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PRESERVING AND PROTECTING FAMILY BUSINESS LEGACIES

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

OF THE

COMMITTEE ON FINANCE
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CONTENTS

OPENING STATEMENTS

PUBLIC WITNESSES

ALPHABETICAL LISTING AND APPENDIX MATERIAL

Communications

PRESERVING AND PROTECTING FAMILY BUSINESS LEGACIES

THURSDAY, MARCH 15, 2001

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:08 a.m., in room 215, Dirksen Senate Office Building, Hon. Don Nickles (chairman of the subcommittee) presiding.

Also present: Senators Grassley, Kyl, Baucus, Conrad, and Lincoln.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA, CHAIRMAN, SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

Senator NICKLES. The Subcommittee on Finance and Taxation and IRS Oversight will begin.

I want to thank my colleagues for coming, particularly my Ranking Member, Senator Conrad, for his joining us today, as well as our panelists.

We have two outstanding panels today. I look forward to hearing their stories, their input, and their advice on how Congress should deal with the issue of the death tax.

I personally have very strong opinions on this. I have learned the hard way about the death tax, personally. My grandfather started a business, my dad built it up, but unfortunately my dad died when I was very young, in 1963.

Estate taxes were very high at that time. We had a closely-held corporation. All of a sudden, the IRS or the government was coming in saying that company is a worth a lot more than what the book value was.

The net result was, we fought the IRS for years. We ended up paying a significant amount of money. In spite of the fact my dad did some estate planning, it did not work. It did not work in any way, shape, or form.

The government, that in my opinion was supposed to protect our property, was confiscating it. I thought it was one of the most unfair taxes in history. My mother did not die, just my father died.

I might mention, we made some changes, some improvements in the tax bill in 1981. We eliminated the death tax for surviving spouses, one of the real positive change that Congress made.

In the 1981 tax bill, which did a lot of things, most people did not pay attention to a few of the amendments. One of the amendments was to eliminate the death tax for surviving spouses, so if an individual passed away, his surviving spouse would not have to pay any death tax.

A little noted or noticed amendment, I had a little something to do with it way back in 1981, and I think it is one of the most pro-family, pro-free enterprise pieces of legislation that we have ever enacted.

So if someone dies today, at least they can be comfortable with the fact that their surviving spouse will not have to pay this very onerous and expensive tax. So, that has happened.

Also in 1991, we reduced the maximum rate from 70 to 50 percent. Interesting, though, in the tax rate reductions that we made between 1981 and 1988 during the Reagan term, we reduced maximum tax rates from 70 to 28 percent. The death tax stayed at 50 percent, and then there was a 5 percent surcharge, so it was actually 55 percent, and in some cases, 60 percent.

So where we reduced all other rates, personal income tax rates down substantially from 70 to 28 percent, the death tax stayed at 50, 55, up to 60 percent. That is too high.

In my opinion, it is not right for someone to work their entire lives, pay taxes on their income for their entire lives, maybe they have done this for two or three generations, to have death occur, and all of a sudden the government come knocking on the door saying, we want 55 percent, we want over half.

That is present law. The present law is wrong. It needs to be reversed. It needs to be repealed. It needs to be repealed in times of surplus or in deficit. This tax is wrong. It is not right for government to take over half of somebody's property because someone happens to die.

If someone works their entire life, and maybe it is building a business, or maybe it is a farm or a ranch, for the government to say, oh, a death occurred, we want half. What did government do to deserve half?

Some people would advocate, let us have a small increase in the exemption. We will exempt, so only the top one or two. Well, what is right about taking half of somebody's property? Just because you are only inflicting pain on maybe 2 percent, does that make it right? I do not think so. I think it is wrong.

I want to make sure everybody understands that, at least this Senator's goal, is repeal. Not a little fix, not something that says we are going to continue having this onerous tax. Somebody says, well, let us have an exemption for $5 million, or an exemption for $6 million, or $10 million. What is right?

If somebody does very well and they build a series of businesses or something that are worth $100 million, is it right for the government to come in and say, oh, they died, we want half? I do not think so.

The proposal that Senator Kyl—and I will call on him after I call on Senator Conrad, and I compliment him for his work—says we should repeal the taxable event, being death. The taxable event should be when somebody sells the property.

If the beneficiaries, or the kids whoever inherits the property receives the property, they should pay taxes when they sell the property. The taxable event should not be death, the taxable event should be when the property is sold. When the property is sold, there are liquid assets to pay the tax.

Right now, in many cases because death is the taxable event, people have to sell in order to generate the liquid assets to pay the tax. That is grossly unfair.

So the proposal that many of us are pushing is to replace the onerous and very high death tax, which ranges from up to 55 percent of a taxable estate of $3 million, 60 percent tax if the taxable estate is $10 to $17 million, to replace that with a tax not on death, but a tax when the property is sold.

Then that tax would be at capital gains, the capital gains rate being 20 percent. It is much more fair, not nearly as onerous, not nearly as punitive, no nearly as dreaded a tax as the current rates.

Plus, in my opinion, you would be freeing up so much in the sector right now, both in the Tax Code and in the private sector where people are spending enormous sums to avoid this very onerous tax.

I mentioned, in my own business I learned the hard way after my father died. I said, I do not want this to be repeated with my kids. I do not want them to have to go through this. I went through years trying to buy back stock that went outside of our family corporation, at great expense, and I did not want my kids to do that.

So I started giving my kids stock, figuring the stock would be a lot cheaper at early ages than it would be at later ages. Some of the kids did not get into the business, so then we had to get the stock back. There are lots of games that people go through to avoid this onerous tax.

Life insurance, in my case and other cases, is purchased. Well, we will have life insurance. A lot of money is spent, again, to avoid this tax. Attorney's fees, legal fees, schemes, foundations, all kinds of gambits that are presently used by the wealthy, and maybe the hope-to-be-wealthy to avoid this onerous tax.

I believe strongly that if we repeal the taxable event, being death, and say the taxable event will be when the property is sold, those things would not be necessary and we would free up enormous economic activity that would be very positive.

I do not think we could do anything more pro-family, more pro-free enterprise, than passing the bill that we passed actually in the last Congress, but unfortunately President Clinton vetoed.

So it is my hope, it is my desire very much, to have that be included in a bill that President Bush will sign, and that I expect he would sign.*

I am delighted with our witnesses. I am delighted to have my colleagues.

I will now call on the Ranking Member of the subcommittee that I am delighted to work with on this committee, and also on Budget, and others, and that is my friend and colleague Senator Conrad.

OPENING STATEMENT OF HON. KENT CONRAD, A U.S. SENATOR FROM NORTH DAKOTA

Senator CONRAD. Thank you, Mr. Chairman. Welcome to the witnesses.

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*For more information on this subject, *see also*, "Description and Analysis of Present Law and Proposals Relating to Federal Estate and Gift Taxation," Joint Committee on Taxation report, March 14, 2001 (JCX–14–01).

After listening to our chairman, it is very clear he and I have a profound difference about what is wrong. I personally believe it would be wrong to repeal the estate tax. I think it should be dramatically reformed. I think the exemptions should be substantially increased so that small businesses and farms can be passed. I would favor going to $5 million for a couple, and $10 million for a small business or a farm.

But I think to repeal the estate tax would prove to be one of the most profoundly wrong things that we could do. I go back to my own reading of history and what happened in Europe with the concentration of wealth, not because of merit, but because of inheritance, and what that meant to social instability and what that meant to preventing the growth of democracy, and what it meant in terms of preventing a meritocracy, which is what our founding fathers believed in. They did not believe in an inherited aristocracy.

They did not believe that children who were fortunate to be born to the very wealthy themselves be given an incredible leg up on everybody else in life, and create a society in which there are two classes of people, those of enormous inherited wealth and all the rest of the people.

Now, that is not to say that is not something wrong with the current estate tax, because surely there is. This is where we do have agreement. The current estate tax bites at much too low a level.

With what has happened to the value of financial assets, it is unreasonable that the estate tax bites at $675,000 for an individual, $1.3 million for a couple. That should be substantially raised.

We should also differentiate for small businesses and farms so that there is a chance to pass on those businesses and those assets to family members unimpeded.

Mr. Chairman, you refer to a death tax. I do not believe that is accurate. There is no death tax in America, there is an estate tax. Let me just go to the chart.

When I say there is no death tax, there is no death tax because 98 percent of the people in this country who die have no death tax. Only 2 percent of estates are currently affected. I would be the first to say that should be changed. Fewer estates should be affected.

But if we look at the numbers, who really pays estate taxes? According to the Internal Revenue Service, in 1998, only 2 percent of decedents, 47,000 estates, were impacted by the current estate tax. Ninety-eight percent were not impacted. Then if we look at, who are the 2 percent that pay, 85 percent of estate taxes were paid by the wealthiest 1 percent.

Now, some have said, gee, it is unfair to have an estate tax because some of the income has been previously taxed. Well, some of the asset gain has not been previously taxed.

In fact, in many cases, it has not been taxed because people bought stock and had a long period of build-up of value, and have not paid capital gains because there was not ever a sale.

I say this to you, that in terms of fairness in taxation, there is almost no tax we levy that I think is fair. I mean, I would like my taxes reduced. There is no tax I pay that I feel is really fair.

The fundamental question is, we have got expenditures for the Federal Government, and the question is, where do we get the money? What is the fairest way to collect the money?

I would say to you, if we cannot look to estates of over $5 million for a couple, over $10 million for a small business and farm, that means we are going to go more to lower income, medium income people to make up the difference.

The cost of outright repeal in the second 10 years is $750 billion, right at the time the baby boomers are starting to retire, adding to the expenses of Social Security and Medicare. You are talking about wrong?

I cannot think of anything much more wrong in my eyes than saying to Mr. Gates' son, you get a pass. We are not going to have an estate tax. Instead, we are going to shift that burden to middle income, struggling people who are going to have to make up the difference.

You talk about wrong? I think that is profoundly wrong and I would fight that with everything that is in me. Not because I do not respect the extraordinary entrepreneurial contribution of Mr. Gates. I do. Thank goodness we have people of that creativity and entrepreneurial spirit and ability.

But the notion that we are going to shift this burden, a massive shift from the wealthiest among us to middle income people and lower income people? It cannot be justified to me. So reform, yes. We ought to dramatically increase the level at which the estate tax takes a bite.

Let me say one other thing. I honestly believe that, under the proposal that the administration has sent up here, which has got it backwards, in my mind, because they do not give relief to the smallest estates first. In fact, they do not remove any estates from taxation for the next 10 years.

What they do, is cut the rates on the wealthiest estates, first. They have got it just upside down. We ought to be expanding the exemption for those estates that are taxable on the low end first.

That is the proposal that I, and others, offered last year that would exempt 40 percent of currently taxable estates in the first year, not wait for 10 years. Let us expand the exemptions so that we relieve the smaller estates of taxation now. Let us not wait 10 years.

I say to you, the notion of waiting 10 years, I think, is a false promise. I believe what will happen at the end of the 10 years, when Congress faces a $750 billion revenue loss right at the time the baby boomers start to retire and dramatically expand the liabilities in Social Security and Medicare, that guess what will happen?

They will pass a new tax under a new name to accomplish much the same thing, and people will have lost the opportunity to expand the exemption to reduce the number of estates that are taxable, and to have a planning opportunity to do an even better job of shielding assets. That is my own strong belief.

So, we have a clear difference here, and I look forward to the hearing.

Senator NICKLES. Senator Conrad, thank you very much.

Senator Kyl, we are delighted to have you join us as well. I appreciate your leadership on this issue for several years.

OPENING STATEMENT OF JON KYL, A U.S. SENATOR FROM ARIZONA

Senator KYL. I actually want to hear from the witnesses, but let me make just a couple of comments.

There is a profound difference of philosophy between Senator Conrad and you and me. Senator Conrad talked about the theory of the estate tax to prevent the concentration of wealth.

Actually, Europe does not collect as much in estate taxes as the United States. In fact, only one country does collect more, and that is Japan. So, those countries do not rely upon an estate tax to level everyone.

Moreover, I have never thought it to be the philosophy of America that the U.S. Government should use its considerable power to ensure that everybody in the country is leveled at death so that everybody here has an equal start.

What this country has always provided, is an equal opportunity so that all could succeed and, hopefully, as many as possible could actually become relatively wealthy.

The American dream of generation after generation here is to leave the next generation better off than the last generation. So, I think we have two very different views of what the philosophy of America really is.

Just two other quick points. The problem with enlarging the exemption for small businesses and farms, for example, which are the primary reason that people initially, at least, got interested in this, is as the American Bar Association section says, it is virtually impossible to qualify for the exemption under this language. It is very, very difficult to write a proposal that treats everyone fairly. So, that is a significant problem with that particular idea.

The last point I would like to make, is that there is a significant fallacy that is perpetuated by those who oppose repeal—and the chart that was shown a moment ago accomplishes this—and that is that only the rich are affected.

Mr. Chairman, let me just cite two or three quick studies here, then we will move on. A February 2000 study by the National Association of Women Business Owners demonstrated that, on average, these female entrepreneurs spent nearly $60,000 on death tax planning.

A June 2000 survey by the National Association of Manufacturers found that over 40 percent of the surveyed respondents spent a total of more than $100,000 on these estate planning devices.

A report issued by the Joint Economic Committee concluded that the existence of a death tax in this century has reduced the stock of capital in the economy by nearly half a trillion dollars, and that by repealing the tax and putting those resources to better use, as many as 240,000 jobs could have been created just over a 7-year period, and Americans would have an additional $24.4 billion in disposable income.

A report by the Institute for Policy Innovation concluded that there is a lot of loss, besides the estates that have to pay the tax, from others who pay the compliance costs, the fact that it discourages savings, that it results in less investment and slower economic growth.

This study estimated that eliminating the estate tax would increase the GDP by almost $1 trillion over the next decade, increase the stock of U.S. capital by almost $1.7 trillion, and create almost 275,000 more jobs. This added growth would ultimately produce over $5 in extra GDP for every dollar in static revenue loss, and within 10 years the cut would pay for itself.

In that regard, by the way, these estimates of a huge cost are absolutely fallacious because they fail to take into account the bill that has twice passed and was vetoed by President Clinton, and will undoubtedly be the legislation that we deal with. That is, as Senator Nickles said, the replacement of the estate tax with the capital gains tax. granted, it is at a lower rate, but it is not an entire revenue loss.

So these estimates are way wrong. In fact, the estimate for the bill that was passed last year was $105 billion over 10 years.

Just a final point, The Heritage Foundation analysis using very conservative models. If the estate tax had been repealed in 1996, then over the next 9 years the U.S. economy would average as much as $11 billion per year in extra output, an average of 145,000 new jobs would have been created, and personal income would have risen by an average of $8 billion per year.

The point, Mr. Chairman, is it is not only an unfair tax, but it is burdensome on the economy. All of those of us who are interested in seeing the economy continue in a robust way see repeal of this tax as one of the ways in which we can stimulate economic growth, as well as being fair to American families.

Thank you, Mr. Chairman.

Senator NICKLES. Senator Kyl, thank you very much.

Next, we are joined by the Chairman of the committee from Iowa, who I think has remarks, and may also wish to introduce his constituents.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

Senator GRASSLEY. Thank you very much.

First of all, I have the privilege over here of introducing not only constituents, but people who are friends as well, Tom and Jan Lovell of Clear Lake Iowa.

Mrs. Lovell, along with her mother and sisters, own a majority of the Clear Lake Independent Telephone Company. She works as assistant manager and vice president of the phone company. Mr. Lovell is a shareholder in the company.

My understanding is that Jan's great-grandfather has been in the telephone business since Alexander Graham Bell invented the telephone. The Lovells are here today to talk to the subcommittee about how their fourth generation family enterprise is in danger because of the death tax.

On that point, I recently read a survey where people who find a business in trouble 3 years after a death, 9 out of 10 have said that the problem was the estate tax.

Opponents of significant death tax relief dwell on one statistic, and seem, from their perspective, to define this debate by reference to that statistic.

The statistic I am referring to is the fact that the percentage of the estates that are subject to the death tax in a particular year, and they would refer to the fact that since only 2 percent of the estates are taxable, the death tax somehow is some really small problem.

Why should we care about those 2 percent, is kind of the question that is always raised. Or these opponents of a significant death tax relief will point out the number of taxable estates in a State and say, why should we care for these people?

For instance, in my home State of Iowa, in 1998, there were 20,000 deaths. Of those deaths, 1,593 were required to file a death tax return. Roughly half of those that filed a death tax return paid the death tax.

Let me say that using these statistics distorts the impact of the death tax. This sort of demagoguery is really a distortion that bothers me.

For a common sense example, we can take this family from Iowa. Their story involves one death, one estate that paid the death tax. Though only one person, the executor, cut a check for the death tax, a heck of a lot of other folks ended up bearing that tax.

I am talking about 26 employees with the Clear Lake Independent Telephone Company. None of these employees are family members. In addition, the family members working at the small phone company included the decedent's surviving spouse, his three daughters, and their families.

So when we are looking at this situation, we are talking about one death and one person affected. We are really talking about at least 33 people affected by the death tax in this one case.

I think, in terms of probably every situation that particularly is a family business, in a very real sense people work throughout a lifetime, living really moderate styles of life, maybe in a family farm, creating one job or a job for the family, maybe you would say, and then doing all they can to struggle throughout a lifetime, then worry about, is that family going to be able to keep that farm when they are not there?

I guess, throughout the 1960's, I think of myself being a State legislator, getting an income from that January through April, then being a factory worker on the assembly line from May through December, then farming at night all during the 1960's just so I could buy a farm.

Then to have somebody tell me that, after I die, that that farm might have to be sold so my son could no continue to farm, that makes me mad.

I do not think it gives proper respect for what people do working a lifetime, early in their years, to get something started and keep it going, then to have something like this come along and take it away.

Now, there are people that make billions, maybe, doing the same thing that I did. Somehow, they do not think it is a problem. I would ask those people who are billionaires to think about the people that live moderately throughout their lives, running the family farm to produce the food that feeds all the other people in America, 2 percent of the people producing the food.

Food grows on farms. It does not grow in supermarkets. People are out there in the wind, the rain, and the sleet, and all the other bad weather to try to get ahead. Then we have people come along and say that there is something wrong with doing away with the death tax? No.

I yield the floor.

Senator NICKLES. Mr. Chairman, thank you very much.

You have introduced the Lovells, and we are delighted to have the Lovells. I will ask all of our panelists if they can keep their remarks to 5 minutes. That would be very appreciated.

So Mr. or Mrs. Lovell, please proceed.

STATEMENT OF JANET AND THOMAS A. LOVELL, CLEAR LAKE INDEPENDENT TELEPHONE COMPANY, CLEAR LAKE, IA

Mrs. Lovell. Thank you very much.

It was just 2 years after Bell patented the telephone in 1876 that my grandfather, Charles Woodford, and some other citizens saw the great importance of this new invention to our new settlement out on the prairie in the heart of the midwest.

Our telephone company has grown to serve 9,000 customers, and today telecommunications fuels economic development and is the lifeline for our rural community. But that lifeline is in danger of being cut because of the Federal estate tax.

Some might ask, what does it matter if this little telephone company has to close its doors because of Federal estate taxes? I would submit that it does matter, because even a small company like ours with less than 26 employees has a strong positive impact which ripples far beyond our doors.

We recently borrowed $9 million to lay the groundwork for futuristic broad-band services. My parents, who were in their mid-1970's, were willing to take this risk. We were willing to take this risk because our customers need the same communications as someone living in a large city.

This kind of investment and local ownership has clear benefits. One example, is when a high-tech software company needed to expand. Because we had the advanced infrastructure in place, we were able to respond immediately and brought 85 new jobs to Clear Lake.

In contrast, we are surrounded by communities, larger communities, which are served by regional companies. They have not deployed high-speed Internet, as we have. They have a waiting list for basic phone services. Offices have been closed and jobs have been lost in the name of corporate efficiency.

In Clear Lake, the creed of "the customer is always right" is followed with the same zeal as it was when my grandfather was operating the company. Our customers are our neighbors. We know that when we see them at the basketball game or church, that they can talk to us and we will respond.

We give back to our community in terms of time and financial resources, to the library, to the United Way, to economic development, to our schools, to environmental efforts, lake water quality, and recycling.

These are the reasons to keep small companies such as ours in business instead of killing them with the death tax. These reasons were important enough to me to leave a journalism career and work my way into the front line of our family business.

We are working hard to balance the demands of a very fast-moving, high-tech society with old-fashioned service and family-centered values. It is a commitment that we have made, in spite of the difficulties of trying to serve our customers, while also trying to make sure that it will not all disappear while we are still mourning the passing of a close family member.

Mr. LOVELL. It was shortly after December 4, 1984, when Jan's grandmother, Esther Ashland, died that we discovered firsthand the potential crippling effect of the Federal estate tax. Our family was working with planners, so we thought we were prepared for the eventuality of the death tax. We soon saw the difficulty of the fair market value as it applied to closely-held corporations.

We filed a Federal estate tax return showing a taxable estate of $3.8 million, with a Federal estate tax owing of $1.4 million. The return was examined, and the IRS increased our valuation by $1 million, which increased the Federal tax by $500,000.

In order to pay these death taxes and preserve the family farm and the family-owned telephone company, all of Esther's liquid assets and real estate, except for her homestead, were sold.

The telephone company used all of its available liquid assets to redeem as much stock as possible. This left the company with a minimal cash position with which to operate.

The valuation of a small, closely-held company is not easy to determine. We used experts who did an analysis of the fair market value, yet the IRS did not accept this valuation.

We have employed professional estate planners and attorneys from Minneapolis to help mitigate the financial impact that the next round of death taxes will have on our company.

The company has spent over $3 million in insurance premiums over the past 8 years to fund a stock redemption program that will generate cash to pay these taxes. We have also placed a conservation easement on our farm.

Unfortunately, we may not be able to accomplish our goal. We may have to choose between investing in our company to provide new services to our customers or setting aside funds to pay the death taxes. We cannot do both. Our final choice may be to sell the company, which would be a loss to our employees and our community.

Some have said that, with a little planning, no one pays estate taxes. Well, that is not true in our case. In spite of generations of planning, the future is uncertain because of the company's ever-increasing fair market value that means so little to us, but everything to the IRS.

We ask you to consider the impact on our employees and our community if we are forced to sell our company to pay this exorbitant Federal estate tax burden. We ask you to consider eliminating the death tax because it has consequences which were never intended, which is the forced sale of small family-owned businesses.

I would like to submit our written comments as part of the record. Thank you.

[The prepared statement of Mr. and Mrs. Lovell appears in the appendix.]

Senator NICKLES. Mr. and Mrs. Lovell, thank you both very much for your statement.

We are joined by my friend and colleague, Senator Baucus from Montana. I would call on him for any remarks and to introduce the next speaker.

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

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

I want to introduce a good friend of mine from Montana, Mr. K.L. Bliss. I have known Mr. Bliss a long time. He is, in Montana, a real go-to guy when you want something done, something accomplished. He is a real, salt-of-the-earth, down-to-earth kind of guy.

So, K.L., I know at home things are really natural, basic, and shoot-straight. Here in Washington, you may feel a little bit nervous because it is a little bit different.

I would just advise you to pretend like you are just a basic guy from Sand Springs, you are down at the Hill Creek Bar, and you are just telling everybody down there what is going on. Just tell it that way, and I think it will come across real well.

Thank you very much.

Mr. Bliss?

STATEMENT OF K.L. BLISS, BLISS LIVESTOCK COMPANY, SAND SPRINGS, MT

Mr. BLISS. Chairman Nickles and distinguished members of the Senate Finance Committee, thank you for allowing me to speak today.

I am a rancher from Sand Springs, MT. My grandfather came to Montana in the 1800's and homesteaded near Broadus. He is featured in these history books about Montana ranching. The sale of that ranch allowed my parents to purchase the ranch my family now operates. I am proud to be a third generation Montana rancher.

In 1973, my brother and I took over management of the ranch. We went into debt to purchase livestock and equipment. During this time, my parents were divorced. To reduce the size of the estate and pass on part of the ranch, their agreement stipulated that my father's half of the ranch be split between my brother and myself.

My brother was killed in a crop spraying accident on our ranch in 1980. His fourth of the ranch went back to my mother. At that time, my mother filed, but did not pay, a Federal estate tax because of the unified credit. I have managed the entire operation since my brother's death.

In order to decrease the value of her estate, my mother started gifting shares of the family corporation to me in the mid-1980's. Having lived through the Great Depression, it was very difficult to convince her of the need for more extensive estate planning. But giving alone would not significantly reduce the size of her estate.

In 1991, I purchased a $200,000 life insurance policy on her that cost over $80,000. My mother and father both passed away in 1998, and I inherited their share of the family operation, as well as over $120,000 in Federal and State death taxes.

My father used a portion of the unified credit when he gifted his property to my brother and I, thus reducing the amount of unified credit available when my parents passed away, making the death tax bill larger than it otherwise would have been.

Prior to my parents' death, Congress created a family business exemption. Had that not occurred, the tax on her estate would have been in excess of $425,000. I would have been forced to liquidate assets that my family depends upon.

For the next 13 years, I will be paying for the death tax. Unlike debt incurred to grow business, tax debt creates no value, reduces wealth, cash flow, and liquidity.

I have tried to do all the right things. Every time we have made a profit, we have reinvested it back into the ranch to improve or expand our business. But $120,000 is a lot to take from a family business.

We do more than talk about the environment, we practice what others preach every day. I have initiated environmental stewardship projects that improve water quality, wildlife habitat, and range conditions. Organizations have recognized our innovation and hard work.

Our ranch was featured in the Winter Grazing Success booklet, which included two national environmental stewardship winners. We were also a host ranch for the 1999 Governor's Range Tour in Montana.

Environmental stewardship is one of the most important things we do as ranchers. We want to pass on the ranch to future generations in better shape than we received it. The money for this work, like everything we do, comes from the family ranch.

With the present death tax, if my wife and I were to die, my son would have to pay up to $2 million to the Federal Government and a significant amount to the State of Montana. In order to pay the tax, he would need to sell a large portion of the ranch.

I have been gifting shares to my son, but at the current non-taxable gift level, it could take hundreds of years to gift the entire estate to him.

Ranches the size of ours are the lifeblood of small rural communities. We provide jobs and support Main Street businesses. The assets I received from my parents were not a windfall. I operated the ranch for 25 years before they died and took a great deal of financial risk that was difficult to manage in the early 1980's.

I started in 1973 with almost no improvements. Today, it is one of the most productive and improved ranches in the country. Hard work should be rewarded, not penalized. For us, a ranch is more than a family business, it is a lifetime commitment. We have worked hard all of our lives on this ranch.

Some would have you believe that only the richest 1 or 2 percent ever pay death taxes. Well, my wife sure does not feel rich. She has the same, cheap carpet we put down in the house in 1976.

This is my reality that could become my son's nightmare.

Thank you, Mr. Chairman. I look forward to your questions.

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

Senator NICKLES. Mr. Bliss, thank you very much.

Our next panelist is Tom Goodner from Duncan, Oklahoma. He is the president and owner of Goodner Supermarkets, which consist of five grocery stores, and also a restaurant. Tom's wife and his three kids all work in the family business.

Mr. Goodner, we are delighted to have you join us today.

STATEMENT OF THOMAS D. GOODNER, GOODNER'S SUPERMARKETS, DUNCAN, OK

Mr. GOODNER. Thank you, Senator Nickles.

Mr. Chairman and members of the committee, my name is Tom Goodner. I am president of Goodner's Supermarkets in Duncan, Oklahoma.

I want to thank the chairman and members of the subcommittee for holding this most important hearing on preserving and protecting family business legacies.

I would like to give you a little background about our family-owned business. My father, Roy D. Goodner, began his career in the retail grocery business in 1937. Our first store was 14' x 16', and we lived in the back of the store. In 1945, he opened a store in Duncan, Oklahoma. I began my grocery career at the age of three, helping sack potatoes in my parents' store.

Gradually, over time, my parents grew the business into a three-store operation. In the late 1960's, my father began to experience health problems and transferred some of the ownership interest to my mother.

Unexpectedly in 1971, my mother passed away before my father did, leaving a substantial estate tax liability. We paid the government over $700,000. My father did not have the cash, so we borrowed the money for the Federal estate tax payment from our local bank, which took seven years to repay.

During that time frame, my father became disillusioned by his potential estate tax liability and I gradually proceeded to buy the business interest from him and other family members.

Today, our business consists of five retail food stores and a restaurant. Currently, my wife Linda runs all office functions, accounts payable, accounts receivable, payroll taxes, and so forth. My two sons, Robbie and Jerry, and daughter Dena, are all actively employed in our family-owned business.

Goodner's employs approximately 700 people in our business. As a family business, we are committed to serving the needs of the communities where our stores are located, and our associates live and work.

As a former chairman of the National Grocer's Association, I can tell you that the independent retailers and wholesalers donate to charities in their communities every day, and not because of the estate tax.

One of the biggest threats to our future viability and growth as a family-owned business is the ominous cloud hanging over our heads, the Federal estate tax.

In the grocery industry, we now compete with multi-million dollar mega-chains with significant financial resources. To stay competitive, we must continue to reinvest in our businesses, remodeling older stores and building new ones, and adding services and new technology to better serve our customers.

For example, just equipment in a 60,000 square foot store currently costs $3.5 million, and the inventory costs are $1.5 million.

The cost of the building and parking lot in Oklahoma runs about $3 million, and that is not counting land, which takes anywhere from 5 to 10 acres.

If my family and employees were to experience my untimely death, the family would face substantial estate tax liability. Having to pay the Federal Government almost 55 percent of the estate would place a substantial drain on our capital base. It would potentially force us to liquidate assets, jeopardizing the future of our company and the continued employment of our loyal employees.

Like many other family-owned businesses, we are asset rich and cash poor. As independent family-owned grocers, we provide diversity in the marketplace, offering consumers and communities competitive choices. Privately-owned retail stores are facing unprecedented competition for multi-million dollar mega-chains and super center competition.

In order to compete, family-owned businesses need capital to reinvest in our companies. The death tax takes needed capital from family businesses. Rather than pay the penalty of the death tax and leverage the company, many family business owners are making the decision to sell.

Repeal of the death tax is the only answer to preserving and protecting family business legacies. It is not fair to tax the same earnings twice, once when you earn them and again when you die. So, we must repeal the death tax, I could not agree more.

We pay income taxes, payroll taxes, unemployment taxes, property taxes, and then we pay the death tax. As a true, family-owned business, we are not a Ted Turner or a Bill Gates, Sr.

I am here today on behalf of the National Grocer's Association and the Oklahoma Grocer's Association to ask for repeal of this unfair and anti-family tax.

The important point, is for the Finance Committee to act now in support of estate tax repeal legislation. Privately owned and operated businesses cannot compete competitively when the Federal Government makes small businesses its indentured servant.

I urge the Finance Committee members to act now to preserve the future of privately owned and operated businesses before it is too late.

I thank you.

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

Senator NICKLES. Mr. Goodner, thank you very much.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

I would like to introduce Mr. Sumption, if I could, on behalf of Senator Daschle and Senator Johnson.

Mr. Sumption grew up on a family farm in South Dakota, began farming in 1966. He has been married to Margaret Sumption since 1971. He and his wife and theirs sons own and operate a farm with a total of 3,300 acres in South Dakota, on which they produce wheat, corn, barley, soybeans, oats, sunflowers, and maintain a herd of 700 beef cattle.

John serves on the board of directors of the South Dakota Farmer's Union and is a member of the National Farmer's Union. His farm is just close by the border of North Dakota.

Both Senator Daschle and Senator Johnson welcome you, and we very much appreciate your coming.

STATEMENT OF JOHN R. SUMPTION, SUMPTION FARMS PARTNERSHIP, FREDERICKS, SD

Mr. SUMPTION. Thank you, Senator Conrad.

Mr. Chairman, I would like to address this committee. As Senator Conrad said, I am John Sumption. I live in Fredericks, South Dakota. I have lived there all my life.

It is an extreme pleasure to be here today. This is an unusual position for me, so I hope you will bear with me.

I was born in 1948. I started farming right out of high school. In fact, I farmed my senior year in high school. I married my wife. She was a schoolteacher at that time, and we have five children.

Four of my five sons have since farmed with me at the present time. They have all attended universities and technical schools, and taken courses in various forms of agriculture.

My youngest son, Warren, who is a graduate of the University of Minnesota, now works in Sioux Falls. But he, too, would like to come back to the family farm.

A year ago, Margaret and I reviewed our estate plan. While most people I know who run family farms, my friends and my neighbors, are already exempt from paying estate taxes, Margaret and I have been extremely fortunate. Due to our prosperity, we are not in this group. Our farm is worth roughly $2 million.

Under the existing tax provisions, our children would have to pay estate taxes upon our death. In order to transfer our farm to our children without creating financial hardship for them, we developed an estate plan around a living trust.

With our plan, we hope our children and grandchildren will be able to benefit from our hard work. I will be providing for their future. However, I do not know what the future will hold.

I plan to review my estate plan every year for many reasons, but most importantly because of the increase in property values could make our estate tax on our farm practically unavoidable under current law.

I understand there are several alternatives under discussion to address problems with the Federal estate tax. These proposals range from gradual rate reductions, ending in complete repeal after a number of years, in an approach that would provide immediate relief to families, small businesses, and farmers and ranchers, who have been fortunate enough to experience growth in the net value of their holdings.

In my view, the most important element that should be considered are increasing the levels of tax exemptions and simplifying the qualification process as soon as possible.

Current exemptions fail to adequately account for the growth in assets of those families who have saved or invested in their own businesses. In addition, immediately expanding the exemption level will reduce the need to develop and maintain estate plans for the purpose of reducing or avoiding tax.

Finally, considering the average age of farm operators and the fact that some proposals would not remove anyone current subject to the tax from potential liability for many years, an increase in the exemption now is extremely important.

To me, reform of the Federal estate tax by immediately raising exemption levels rather than repealing a tax after many years makes sense for family farms, regardless of any impact it may have on the Federal budget surplus or other tax reform measures.

The National Farmers Union supports increasing the estate tax exemption covering estate values of $4 million per person, which would result in an exemption of $8 million per couple.

That level would certainly take care of my farm, as well as any estate tax hardship faced by farmers and small businesses owners that I know.

Mr. Chairman, I am not an expert in taxes, but I know about family farms. They are my friends and my neighbors. They are not worried about taxes because, in the most part, they do not have to pay them.

They are worried, however, about the price they receive for crops and livestock, about good public schools for kids, and about local community services, paying prescription drugs, being able to pay their bills, and retirement. Of course, they are always worried about the weather. [Laughter.]

I fear we may not be able to do the things we want, and need, for our communities if we repeal Federal estate taxes. To me, it does not seem responsible to eliminate the tax for everyone, including billionaires, when they do not need the help.

A more targeted approach to help families better address the issues now will retain more resources for their other needs, public investments, and improvements in our future. It seems to be a more practical approach.

One final comment. As a farmer and rancher, Main Street business and rural communities are in real trouble right now. If you really want to help fix the Farm Bill, the safety net, improving conservation programs, expanding rural development, and addressing agriculture concentration will do more for rural America than any estate tax repeal.

Mr. Chairman, thank you for the opportunity to speak with your committee today about estate tax reform. I look forward to responding to any questions you may have.

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

Senator NICKLES. Mr. Sumption, thank you very much.

Next, concluding our first panel, is William H. Gates, Sr. Mr. Gates is representing Responsible Wealth, a nonprofit corporation.

He has been a private attorney for 48 years in Seattle and is the founding partner in the law firm of Preston & Gates.

Currently, Mr. Gates is co-chair of the Bill and Melinda Gates Foundation.

Mr. Gates, welcome.

STATEMENT OF WILLIAM H. GATES, SR., RESPONSIBLE WEALTH, A NON-PROFIT CORPORATION, BOSTON, MA

Mr. GATES. Thank you, Mr. Chairman. I appreciate the invitation to come to speak to you.

I live in Seattle, Washington. I have been a resident of that area all of my life. I am 75 years old. I have engaged in the private practice of law in Seattle for 48 years.

I am not speaking on behalf of the Bill and Linda Gates Foundation. I am not speaking on behalf of the Bill and Linda Gates Foundation.

First of all, let me say that there is a misconception about the list of folks who have joined me in opposing the repeal of the estate tax. There are some super-wealthy individuals, but the majority of the signers are like the individuals testifying here today. They are the "millionaires next door," as one book describes them. They are folks with wealth in the $1 to $10 million area.

Many of the signers of our position are people who are owners of family-owned businesses and enterprises, and they are all folks who will pay estate taxes. What brings us together, is our belief that the estate tax should be reformed, not completely repealed.

While we may not be able to ensure that all children start life on a level playing field, that is something we should strive for. The estate tax helps us get closer to that ideal.

A good life should be something which is achieved, it should not be delivered as a result of the womb you happen to start out from. I think the estate tax is an entirely appropriate tax. I accept it, as I do Federal income taxes, as the price of living in the United States and being a U.S. citizen.

It is appropriate that a tax be imposed on those who have so very fully enjoyed the benefit of the things that this country provides: schooling, order, freedom, encouragement to succeed, models of success.

In a very practical sense, the wealth one accumulates derives as much from the environment in which this grand Nation makes life possible than it is the personal talents or efforts of the individual involved. It is perfectly appropriate that the cost of the maintenance of this grand Nation be paid back in proportion to what has been extracted.

Let me illustrate that point. This is a hypothetical, obviously. The scene is God's office, and he has called two about-to-be-born babies into the office. He said to them, you two are the next two people to be born on earth. One of you will be born in the United States of America, one of you will be born in Ethiopia.

Now, I have got a problem. The stock market is not doing very well and my Treasury shows prospects of being inadequate over the years ahead. I need to replenish it. So I am going to auction the right to be born in the United States.

I will hand you each a piece of paper, and I want you to write on that piece of paper the percentage of your net worth that you are willing to commit to the Treasury of God on the day of your death. I will tell you, that the one of you that gives me the highest number will be born in the United States.

Now, does anybody here think that number would be lower than 55 percent? The privilege of American citizenship carries duties with it.

In the present setting, when new packages are being designed, it seems to me particularly bad policy to subtract from the necessary revenue the sums produced by the estate tax.

Those dollars are going to have to come from somewhere else, from someone else. It is perfectly clear that the someone else will be a citizen with much less ability to pay than the heirs of our wealthiest people, and that includes my daughters.

Let me say, in addition, that I very much doubt that anybody has properly calculated the impact of repealing the estate tax. I do not think we have begun to appreciate, and I do not believe any old statistics would show us, the amount of individual wealth that exists in this country today.

The estate tax source could be a very, very important source of revenue for this country. It is appropriate and it affects only the very wealthiest among us.

I understand that the purpose of this hearing is to consider the merits of the estate tax and whether it should be reformed or repealed. I do not think the committee can make an informed decision on that issue without considering the impact of the estate tax on other activities.

By that, I, of course, refer to charitable giving.

Senator NICKLES. We will give you——

Mr. GATES. Thank you very much, Mr. Chairman.

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

Senator NICKLES. Mr. Gates, thank you very much.

Now, we have another panel, too. I wish to have all of our colleagues to have a chance to ask a couple of questions, so I will ask all of our colleagues to be kind of brief on questions.

Mr. Gates, just a couple of quick questions. You are chairman of the foundation. There is a lot of big, charitable foundations. You happen to be chairman of one of them.

Do you think the purpose of those foundations are primarily for charitable good causes or are they primarily for tax avoidance?

Mr. GATES. I think they are primarily for good causes, sir.

Senator NICKLES. Good.

Mr. GATES. I think that the presence of the estate tax is an inducement to making charitable requests.

I had a client, who will be Mrs. Smith. She had about $8 million and three children. She was a surviving spouse. She felt a great obligation to her university because she and her husband had graduated from that university and felt it was entitled to something. It concerned her that they were hoping she would give them $2 million, and it concerned her on that impact on her children.

She thought about it, and she sat down and talked with her children. She said, now, kids, we have got about $8 million here, and I am thinking seriously about giving the university about $2 million.

Now, it looks like it will cost you each somewhere in the neighborhood of $650,000. But you have to understand that, because of the Federal estate tax, it is only going to cost you a little over $300,000. The kids said, that is not so bad. Why do you not go ahead and do that, mom?

Senator NICKLES. Let me just ask you a couple of other questions. Some people say the wealthy do not pay the tax. I do not know what your wealth is. That is not my business.

Have you personally spent a lot of time and money in estate planning to reduce your estate taxes?

Mr. GATES. Mr. Chairman, I am perfectly willing to have you understand that, because there is a lot of misinformation about me. I expect to pay an estate tax. If I were to die tomorrow, I would pay an estate tax of $6.8 million. I am not a billionaire, I am not super-rich. That $6.8 million would come from my children.

I am fairly sophisticated about this and I know exactly how to avoid paying estate taxes. One, is to spend it all before you die, and I am working on that. [Laughter.] The other, is to be married and to give it to your spouse. The third, is to give it to charity. Anything else is minute fractions.

Senator NICKLES. You obviously favor the estate tax. Do you want to make a pledge to contribute 55 percent of your estate to the government?

Mr. GATES. If you repeal it?

Senator NICKLES. No. I said, do you personally want to? Some people do not want to. I think you have got another group on the panel that says, maybe you want to pay 55 percent, but I am guessing, I heard Mr. Goodner, Mr. Bliss and others.

Mr. Bliss said that if he passed away he would owe $2 million. Mr. Goodner did not give an estimate, but he said he had a company that has 700 employees, and he would have to pay, I am going to guess, millions of dollars of estate tax.

I do not think they are in the same category. So my point is, they do not want to break up the Goodner enterprises or the Bliss ranch to pay estate taxes. You do. I mean, if you are willing to contribute 55 percent of your estate, you can pledge to do so, and you can do so.

Mr. GATES. Sir, what I think, is that there should be a tax that we all pay. I am willing that there be such a tax. I do not put it in terms of some kind of gift of mine to the government. If you repeal the estate tax, I do not expect to write a check for $6.8 million.

Senator NICKLES. But you could. We would make that option available for you. [Laughter.]

Mr. GATES. So could you.

Senator NICKLES. No, I could not. I would not want to, either.

Senator Conrad?

Senator CONRAD. Well, I think, in a way, we wind up always in this town with false choices. The false choice is not small businesses and farmers paying an estate tax or repeal the estate tax. Those are not the choices. We can alter the current estate tax, dramatically raise the exemption so that the smallest estates that are currently taxable are exempt.

I would favor a plan that goes to $5 million for a couple and $10 million for small business and farms. Certainly from what Mr. Bliss describes, it would exempt him. I do not know about the Lovells, and I will not ask you because I do not think it is appropriate. You do not come here to reveal your personal business. Nor would I ask you, Mr. Goodner.

But that would take care of the vast majority of currently taxable estates. That would take care of more than two-thirds of them. They would have no estate tax. I would do it in a way that is fully portable between a couple so they did not have to engage in any planning. I think that would be fair and a much-improved system.

But I must say, I do not think it is wise to completely eliminate it on the very wealthiest estates because it would lead to, in my view, an aristocracy of wealth that has nothing to do with merit, that has simply to do with inheritance. I do not think that is a healthy system.

The question to me is, where is the right level at which you completely exempt estates? My own view is, we ought to go to $5 million on a couple very quickly, and $10 million for small business and farms. You would have a fraction of the estates that would have any tax liability.

Mr. Gates, I understand you support reform. So you are not saying that it is not right to increase the exemption, I take it.

Mr. GATES. No. I had not heard figures as large as the one you just advanced, Senator, but I think that is exactly what you would have.

Senator CONRAD. Mr. Sumption, in terms of your neighbors and the people that you deal with, do you believe an increase in the exemption to the levels that I mentioned would take care of most of your neighbors?

Mr. SUMPTION. Absolutely. I have five bachelor uncles and my dad, and they originally had a partnership that was separated in the 1950's. If you took the entire wealth of the Sumption uncles and my dad and kept it in one operation—and one of the biggest obstacles my sons face is the Sumptions own too darn much already—if you put it all together, it would still be exempt under those numbers. They farm entire townships, if you added them all together.

So I do not see an advantage to my community eliminating a revenue source that runs this government. I come from a community that is shrinking every day. I spent 9 years on the school board in the last 15, and I watched Federal dollars leave, and leave, and leave, and the mandates are still there.

I got a great education. I quit at high school. My kids got a college education because they need it in today's world. You cannot keep reducing the level of support to rural America, or any other part of America, without jeopardizing democracy.

Senator CONRAD. Thank you.

Mr. Chairman, in an interest of having opportunities for other members to question and to get on to our next panel, I will withhold.

Senator NICKLES. Thank you.

Senator Kyl?

Senator KYL. Thank you, Mr. Chairman.

Just one question, Mr. Gates. Do you have any evidence, other than just anecdotal evidence, that charitable giving would be reduced as a result of the repeal of the death tax?

Mr. GATES. I have evidence from 48 years of practicing law, Senator.

Senator KYL. Anecdotal evidence.

Let me just cite a poll to you, a public opinion survey, and see what you think about it. This is a Harris poll, in November of last year.

Wealthy people were asked how repeal of the estate tax would affect their giving; 73 percent of wealthy individuals said it would have no effect at all, 19 percent said they would increase their giving.

The results were even more dramatic for older individuals; 56 percent expected no change in their charitable giving, about 43 percent expected to increase their charitable giving.

Is your life of experience contrary to this very recent Harris interactive survey?

Mr. GATES. Yes, it is. I suspect that the proposal to permit more people to itemize deductions on income tax deductions is also based on the assumption that taxes are an inducement to charitable activity.

Senator KYL. They seem to be an inducement to your charitable giving. Is that not correct? In other words, you said you wanted to spend all your money, if you could, before you died. You are also contributing a significant amount to charities, to foundations, and so on.

So the tax policy has induced you to try to avoid paying more taxes to the government by either spending it or contributing it to charity. Is that not right?

Mr. GATES. Yes. I think it is a mix, Senator. If you ask me, would I have done it if there were no estate tax? I think in my case the answer is yes.

Senator KYL. I will bet you would have given a lot of it, would you not?

Mr. GATES. Pardon me?

Senator KYL. I said, I will bet you would have given a lot of it. Maybe not exactly the same amount, but a lot of it.

Mr. GATES. Yes.

Senator KYL. I am sure you would have.

Thank you, Mr. Chairman.

Senator NICKLES. Senator Kyl, thank you very much.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

The question I have is basically for ranchers, farmers, and small business people who are very much concerned about this. What choice do we want to make? Because, as you well know, it is a question of a bird in the hand worth two in the bush.

That is, the repeal of the Federal estate tax, as proposed by the President, does not take effect for 10 years. It is not now, it is not next year, it is out 10 years from now. That is when it is repealed.

The timing is based upon a lot of assumptions, assumptions of budget surpluses that requires the economy to do very well over 10 years. It is because of those assumptions that the President has suggested repeal in the tenth year. Frankly, the revenue that taxpayers would gain or lose, that is, revenue lost to Uncle Sam, would be even higher in subsequent years. Much higher.

So the question I think you face, and we face, is whether to have reform now along the lines suggested by Senator Conrad or something similar—that is the bird in the hand—or not.

That is, total repeal, but not until 10 years from now when it is so iffy as to what the economy is going to look like. We don't know now, whether the Congress is actually going to fully repeal, or whether it is going to continue to postpone repeal off in future years as it sometimes does.

Add to that another consequence. In the President's proposal, it looks like they will repeal a step-up in basis, which means that your heirs could well pay very hefty capital gains tax because of property appreciation, which is probably very significant over time, and also because debts will be carried over. They will have to pay the debts off, too.

So we are faced with a trade-off. Are you willing to bet on the future for a full repeal, or take significant reform today immediately?

Another point to remember, if step-up of basis is repealed so there is no step-up of basis at death, there are all the administrative complications of trying to figure out what the basis really is. And in addition to that, because of appreciation, the capital gains tax to the heirs could well be pretty high, pretty hefty. Those are the real choices before us.

There is a lot of theoretical talk about a lot of other things, but the practical application of the decisions before us are essentially what I have just outlined. I just would be curious, given that choice, what you think makes the most sense as a farmer, or rancher, or businessman.

Mr. GOODNER. Well, I will tell you this. I think the tax is wrong. I think it is an unfair tax. I think it is completely wrong. I would like complete repeal, do away with it, and I will take my chances. I think, down the road I do not know what is going to happen. Right now, we have to survive.

Senator BAUCUS. As you know, it is not repealed until 10 years from now.

Mr. GOODNER. That may be true. But, still, I will pay my taxes. I just think it is a wrong tax. Basically, I just think it is completely wrong and should be repealed.

Senator BAUCUS. Mr. Bliss?

Mr. BLISS. I am not exactly sure what the basis is as far as the time of purchase or the time of inheritance when you talk about a stepped up basis.

Senator BAUCUS. I am talking about the time of purchase, usually. Usually the basis is a lot lower values than at the time of death, so you pay a much higher capital gains tax.

Mr. BLISS. In our case, if we went to a capital gains on our original basis, we would have significant tax because it was purchased a long time ago and at a fairly low level. Given the tax record, the government sometimes to help us, I, too, question if waiting 10 years is a good idea. I think that we need something realistic and we need some help right now.

But again, I do not feel that just because you are more successful than your neighbor, that you should necessarily just fall to one side or another of an arbitrary line. Still, those people have worked hard through rock, hard work, or whatever. Why should the person that has less than a $10 million ranch get away and the guy that has a $12 million one pay?

Senator BAUCUS. I know it is hard to know exactly, but just your gut reaction to Senator Conrad's proposal. That is, today, this year, an exclusion of $5 million or $10 million, and lower the rates. I do not know if that is part of his proposal or not. At least, raising the exemption today, versus 10 years from now total repeal, but not stepped up basis, with an additional 10 years of capital appreciation.

Mr. BLISS. There are a lot of people that are going to need help today.

Senator BAUCUS. All right. Thank you.

Mr. SUMPTION. Can I comment on that?

Senator BAUCUS. Sure.

Mr. SUMPTION. If we do not receive help right away, I mean, my dad is 88 years old. He is in the middle. We buried a 90-year-old uncle in January. I buried my mother last November. We have already paid tax and we are not going to live 10 years.

My family is not going to live 10 more years. I have five sons that want to farm. I will never be any better off than I am today if I help them get started, so I have nothing to worry about. But they do.

These are genuine, hardworking men that have done nothing but work their whole lives. They went to a rural, eighth grade education in a country school and they have done nothing but work.

They deserve some relief so they can give their estates where they want them to go. These guys do not. They are not sophisticated individuals. They are loyal, hardworking farmers. They are not going to live 10 more years. It will not do any good if you do not change the law this year.

Senator BAUCUS. Thank you.

Senator NICKLES. Mr. Sumption, thank you very much.

Next, I will call on Senator Lincoln. I would encourage everybody to be very quick. We just found out we have three votes stacked at 11:40. We have another panel. It is my intention to hear that panel before we adjourn, so we are going to have to go pretty quickly.

Senator Lincoln?

Senator LINCOLN. Thank you, Mr. Chairman. I will be very brief.

I come from a seventh generation Arkansas farm family, and I want to thank the panel very much for your testimony today and your willingness to share with us your personal situations, as well as your views and outlook on what it is we can be doing here to better support our family businesses, our family farmers, our small rural communities.

I just want to pledge to you that I am devoted to working something out that is going to bring about some more immediate relief. I do think that that is important as we look at what rural America is going through.

Not everyone has the same situation, certainly in terms of the panel that is here, and all individuals that are out there. I am hoping what we can do is, through this committee, be able to come up with something that is going to be fair and just for everyone, but that is also going to be helpful in moving the Nation forward.

In looking at my own situation, I think the only thing more difficult when you look at estate taxes and figuring out what is going to happen or how it is going to happen, is trying to make a decision among nine different cousins, which is always difficult in any estate.

But I will not ask any questions. I think we have tried to press the point of what our options here in the U.S. Congress in terms of a complete repeal, doing it sooner than later. President Bush's proposal, which really sets that relief to you all and to us as families, is further out there.

I am in agreement that the sooner we do it, I think the better off we can be, but that we also have to make the pieces of that puzzle fit with the other types of tax relief that we want to be able to offer families.

But I would like to, in closing, just associate myself with the comments of Mr. Sumption, who stated at the end of his testimony how critical it is that we do other things for the agricultural community and the people of rural America, whether it is conservation programs, the Farm Bill, and other things.

There is no doubt, as he has expressed in his own family situation, that being able to pass along that family farm, being able to do something in terms of building that for their family, has a lot to do with the price that they are getting for their commodities and what else is going on in agriculture in this day and age.

So, I thank you, Mr. Chairman. I look forward to working with you and others. I do hope that, in a bipartisan way, we can produce out of this committee something that is going to benefit everybody, as well as our Nation. Thank you.

Senator NICKLES. Senator Lincoln, thank you very much.

To our panelists, I would like to continue, but I want to get our other panel. So, I will ask you to please be replaced by the next panel.

Thank you very much for your cooperation for the committee.

Senator CONRAD. Thank you all. You were very excellent witnesses.

Senator NICKLES. Again, I apologize to our second panel. In fact, we have these votes, but I think we have ample time to have everybody make their statements.

Our first panelist is Gary Robbins of the Institute for Policy Innovation. Mr. Robbins will discuss the history of estate tax and their dead weight impact on the economy.

Mr. Robbins, please go ahead.

STATEMENT OF GARY ROBBINS, PRESIDENT OF FISCAL ASSOCIATES, TESTIFYING NO BEHALF OF THE INSTITUTE FOR POLICY INNOVATION, ARLINGTON, VA

Mr. ROBBINS. Thank you, Mr. Chairman and members of the committee.

I am Gary Robbins, president of Fiscal Associates and senior research fellow at the Institute for Policy Innovation. I thank you for the invitation to appear today. My statement is based on work on estate tax that Aldonna Robbins and I have been doing for IPI.

I would like to summarize my statement. I have also provided the committee with three tables that provide historical highlights of estate tax legislation.

Several main points emerge from the history of estate taxation in the United States. Until 1920, estate taxes were used as a sporadic and temporary way to finance wars. When hostilities ceased, the tax was repealed.

From the 1920's through 1940's, estate taxes became another weapon in the arsenal to redistribute income. Graph 1 in my presentation shows the top and bottom estate tax rates since 1916.

Loophole closing and preoccupied tax reformers during the late 1960's and early 1970's culminated into a 1976 tax bill that combined the estate and gift tax exemptions into a unified credit.

Since then, estate taxes have generally been on the rise. At this time, a weapon in the arsenal to reduce Federal deficits. Time has seriously eroded the value of the estate tax exemption.

The estate tax has a large dead weight loss because the estate tax falls on assets. It reduces incentives to save and invest, and therefore hampers growth. This is on top of income taxes.

This unequal treatment of income leads to an inefficient mix of capital and labor. The size of the dead weight loss depends on how much of the Nation's assets are subject to the tax and the amount of the distortion.

The estate tax exemption determines the proportion of wealth covered and the rate structure determines the degree of distortion. A rough measure of the distortion is the ratio of the marginal-to-average tax rate for those paying the tax.

Under a uniform tax, the ration would be one and the amount of distortion would be minimal. The greater the difference between the marginal and average tax rates, the greater the distortion and the greater the dead weight loss.

Currently, the marginal estate tax rate is nearly three times higher than the average, due mostly to the unified credit. In 1916, the statutory exemption was $50,000. However, adjusting that exemption for growth and wealth between 1916 and 2001 indicates that estates under $11 million in today's wealth would have been exempted.

As Graph 2 shows, however, from a high of $13 million in 1931, the real value of the exemption has fallen dramatically. Tax bills in 1981 and 1997 provided modest increases in the exemption. However, the exemption of $675,000 in 2001 is still a far cry from the $11 million counterpart in 1916.

This failure of the estate tax exemption to keep up with rising wealth is the main reason that increasing numbers of average Americans face the prospect of having their heirs presented with an estate tax bill.

Middle class families who own a house, have an IRA, 401(k), or some other retirement account can easily exceed the $675,000 today, or even $1 million 5 years from now.

Both the lowest and highest tax rates also have gone up significantly since 1916. As a result, more of taxable estates are taxed at the highest marginal tax rate. As Graph 3 shows, in 1960, only estates of over $1 billion in today's wealth would have been taxed at the top rate of 10 percent. Contrast that with the top rate of 55 percent on estates of $3 million in place today.

The applicable rates are more compressed than Graph 1 suggests because of the unified credit. Under the unified credit, the effective bottom rate is not that statutory 18 percent shown in the graph. Rather, 39 percent. In other words, the current effective tax rates range between 39 and 55 percent, and that lowest effective rate will rise to 41 percent by 2006.

In summary, the estate tax is one of the most inefficient features of our current tax system. Its sheer complexity results in high compliance costs, as much as the estate tax raises, by some estimates. This warrants serious reduction or outright elimination of the estate tax.

Failing repeal, the exemption should be raised significantly. Increasing the exemption to the range of $5 to $10 million would partially restore the proportion of wealth subject to tax to be more like comparability to the 1920's and 1930's.

But this only partially addresses the impact of the tax, however. Under the unified tax credit structure, the raising the exemption amount above $3 million would make the lowest marginal tax rate 55 percent, meaning the tax would be even less efficient than the current law. While the amount of wealth subject to tax would be reduced, the rate structure would be harsher.

The other desirable changes would be to expand the rate brackets because of the compression I alluded to, or to reduce estate tax in general. However, the best solution would be to eliminate the estate and gift tax altogether.

Thank you.

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

Senator NICKLES. Mr. Robbins, thank you very much.

Our next panelist will be Dr. Steger. Dr. Steger is president of Consad Research Corporation in Pittsburgh, in addition to being an adjunct professor of Policy Sciences at The Heinz School at Carnegie Mellon University.

Dr. Steger?

STATEMENT OF WILBUR A. STEGER, PH.D., PRESIDENT OF CONSAD RESEARCH CORPORATION AND ADJUNCT PROFESSOR OF POLICY SCIENCES, THE HEINZ SCHOOL, CARNEGIE MELLON UNIVERSITY, PITTSBURGH, PA

Dr. STEGER. Senator Nickles, Senator Conrad, Senator Kyl, I am distinctly honored and fortunate to be appearing before this very distinguished, august, and sometimes impassioned panel over these subjects.

My own interest, of course, began in 1951, so this will be the 50th anniversary of the beginning of my doctoral dissertation at Harvard, culminating in 1955. I have had the honor of bringing to the attention to every President of the United States since President Kennedy, with the one exception of President Ford, this subject.

I must say, every time I had a discussion with these people—discussion, and quite often in correspondence in the cases with President Bush and President Clinton—the emphasis would frequently turn around to family business and farms, and what have you.

I am not surprised that there has been a vast improvement over the years. But the question still is as to where it is now. There is no question that those problems were, as you said, Senator Nickles, "hardly taken care of."

The difference between all of those discussions and the ones that we have here today is very formidable. In fact, it is one that I am really in awe of. That is, you now have a decision to do something about the estate tax, at the same time you have decisions concerning the implications for capital gains. I cannot remember both of those things coming together in a conversation with any of these people.

The only thing I really mind about the fact that it has only been 50 years I have been looking at this, is I missed President Truman, because he would have been somebody to talk to about this when it comes to small and family business.

There is a very lengthy history to this whole thing, and part of this has been covered by Mr. Robbins. You have to go into the history to really get a sense of some of the problems.

It has been frequently quoted that, during President Carter's time, for example, that President Carter had the difficulty of being able to sort of take the carry-over basis and implement it, if some of you can recall that. In a personal conversation with President Carter about that very thing, he told me that he was trying to take a sample and see what it would be, to have a carry-over basis implemented. Staff would come to him and say, "it is really hard." It is really hard to do that.

What President Carter told me was, if he only had $50,000 more at that time to be able to study the sample of 500 people, he could have come up with a solution. He did *not* get the money.

There are four points that I want to make, very, very quickly that have come out of our current, ongoing studies. Most of the studies that we do in the area of Consad are financed by ourselves. Occasionally they are sponsored by others.

The first question is the magnitude of the problem. This is a big problem. Some people say it is 1 percent or 2 percent of the total taxpaying population. That is a very, very restricted definition of the size of family business and other consequences.

A Treasury study, and one that we looked at in great detail, says there is something like 20 to 25 percent of the estate taxes paid by family businesses, in which case, instead of 500 businesses which some estimates have been, it is more like 10,000 businesses.

If it is 10,000 family businesses a year, that is 1,000,000 jobs. In 10 years, that is something like maybe 10 million people, because the average family business is about 100 persons.

So, you are not talking "chicken liver!" You are talking about really a lot of people, and a lot of business. So putting aside the precise magnitude, it certainly is a very, very big problem.

The other factors that we looked at are the economic effects. In the economic models that we have been running, we are seeing something like a $60 billion difference in GOP between paying the estate tax and not paying the estate tax.

Why has that happened? It does because the money is taken out, prepaying, if you will, the estate tax by virtue of trying to plan for it. As a result, what happens is that money is diverted out of the business, naturally, and is diverted to accountants, insurance people, and service people. There is no question that that goes into the economy, but a different kind of thing in the economy.

Our estimate is that something like 4.5 million out of the 5 million firms benefit by keeping the money in the ways that it ordinarily would be, a lessened or no estate tax.

When it comes to revenue losses, our feeling is that not all the money would be recovered by the accrual of basis, but something like maybe a half to two-thirds would be, which would mean that the $236 billion revenue loss would become closer to probably $100 billion or less.

Another very important thing. There is something like approximately $15 trillion worth of unrealized capital gains. It is like a tidal wave. It is all around us. It does not have to be taxed, obviously. They can be exempted, and what have you. But that is something we really have to solve. By partly doing away with this stepped-up basis, it will begin to get solved.

What will happen, is that for people who are about to realize that the stepped-up basis is gone at the point in time that it is, they will start to realize their gains more. The other people, of course, are going to realize it during the carry-over process.

Finally, when it comes to preserving family businesses and simplification, there is no question that the repeal and/or substantial reform would probably take care of a lot of problems.

Thank you.

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

Senator NICKLES. Dr. Steger, thank you very much.

Our next panelist is Professor Abrams. He is professor of Law at Emory University. He is also former director of Real Estate Tax at Deloitte & Touche. He will be testifying about a study on behalf of the Real Estate Roundtable on the implications of real estate owners of estate tax repeal and carry-over basis at death.

Professor Abrams? Thank you.

STATEMENT OF HOWARD E. ABRAMS, PROFESSOR OF LAW, EMORY UNIVERSITY, AND FORMER DIRECTOR OF REAL ESTATE TAX KNOWLEDGE, DELOITTE & TOUCHE, LLP, ATLANTA, GA

Professor ABRAMS. Thank you, Chairman Nickles, Senator Conrad. I appreciate the opportunity to speak here. I would like to make clear that I am speaking for myself, and these are not the opinions necessarily of Emory University or any other organization.

I come actually to address some very narrow, specific issues related to the income tax if estate tax repeal, in fact, is in the cards. But before I do that I would like to spend a minute at most, perhaps, on repeal versus reform because, frankly, in large measure I agree with Senator Conrad that, as a theoretical matter, there is much to be said for maintaining an estate and gift tax structure.

Unfortunately, that theory is not relevant, I think, to today's tax structure. That is why I would advocate repeal of the current system.

The measures that tell us how much people pay, the 1 and 2 percent, are very imprecise, as we have heard, in large part because the tax is not paid to the U.S. Government.

The tax is paid to estate planners, it is paid to investment brokers, trust administrators, lots of insurance companies. It is a very inefficient tax in the sense that the costs are very high and the revenue of the government is very low.

If one wants to pay for improvements, and freedom, and schools, there are ways to do it. But it is not by paying, frankly, people like me to draft bypass trusts. Unfortunately, that is the situation we have.

So it seems to me, even if one advocated some sort of transfer tax system, the one we have is not one that can be in any sense, frankly, preserved.

If, however, we are to repeal the estate and gift tax, we need to make sure we get the details done right because nothing can be more fatal to a major revision than discovering that there are problems with the implementation.

I am reminded that even the smallest leak can sink the largest boat. I would like to see this reform effort be accomplished in a way that will, in fact, survive. That means we need to look at the income tax consequences.

In particular, it looks politically as if repeal of the estate and gift taxes will bring with it a carry-over basis at death rule to replace the current step-up in basis rule. That has a number of advantages, but it also has some practical problems.

I would like to explain, first, that if we went to such a regime we might be faced with death still being a taxable event, although it will be an income taxable event. That is because, under current law, if you make a gift of appreciated property and that appreciated property is encumbered, the gift can be taxable. If your basis is 10 and the property is subject to a debt of 50, you pay a tax on 40.

It is my belief that nobody believes that regime should be continued in the context of death. It is easy enough to fix. It simply requires not only that Congress provide there be a carry-over basis at death, but they also provide, just as they have in Section 1041, that there be no gain or loss recognized to the transferor by reason of death or transfer from the decedent's estate to the beneficiary.

It is a technical change, but an important one. If we did not include this, we would again have the problem of people having to sell small farms and businesses to pay for taxes by reason of death. Again, technical. I frankly do not find it particularly partisan, but I think it is something important to identify in advance.

If, though, we go to a true no-taxes-at-death carry-over basis regime, it could be the case that when somebody inherits highly appreciated property and they sell the property, they will have less in receipts than it will take to pay the income tax and the debtor. And the debtor is not about to forgive the debt.

One system is to live with it. I am hopeful that is not the system you will choose. The well-advised, people who can afford people like me, will see this coming and disclaim, or they will buy insurance; there are a number of possibilities.

But the moderately wealthy, the $10 million, the people who have seen their houses in Ponca City go up, as my in-laws have, who have seen their DuPont stock, their Connaco stock go up, I do not think of them as wealthy, and they do not think of themselves as wealthy, but they could have a significant liability.

In my opinion—and there are a number of proposals in the written remarks I have asked to be added to my oral statement—there are three possible responses to this. The one I would like to advocate the most is a very limited, targeted approach that benefits, essentially, real estate by looking to rules currently in existence under 465, the Anti-Tax Shelter At Risk rules.

It would simply provide for a step-up only to certain qualified, non-recourse financing as it applies to real estate. The virtue of that is, real estate is the area in which this problem is the most extreme.

The statute is already in the law. It was tailored to be anti-abuse—it is in the At Risk rules, after all—and will provide a very limited solution to what could otherwise be a very unfortunate problem.

Thank you for asking me to speak today.

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

Senator NICKLES. Professor Abrams, thank you very much.

Our next panelist is Stefan Tucker. He is former chair of the American Bar Association, Section on Taxation. He is also a private attorney. He will be discussing the relationship of estate and gift tax to income and capital gains tax.

Mr. Tucker, thank you very much.

STATEMENT OF STEFAN F. TUCKER, PARTNER, VENABLE, BAETJER, HOWARD & CIVILETTI, LLP, AND FORMER CHAIR OF THE AMERICAN BAR ASSOCIATION, SECTION OF TAXATION, WASHINGTON, DC

Mr. TUCKER. Thank you, Mr. Nickles, Mr. Conrad, Mr. Kyl. On behalf of everybody, I appreciate your being here and part of the process. This is a very important and historic process, and there are a lot of things we can do right, and there are things that maybe we can do wrong, and you are certainly focusing on that.

When I was chair of the American Bar Association, Tax Section—and I am only speaking as a private practitioner this morning—I was up here talking to the Senate Finance Committee and the House Ways and Means Committee about the need to simplify the Internal Revenue Code. The elimination of the estate and gift tax and focusing on the Federal income tax will not simplify the Internal Revenue Code.

There are things that can be done to simplify the Federal estate and gift tax. I wish, no matter what else you do, you would eliminate the generation-skipping transfer tax. It is easier to figure out how Stonehenge occurred than it is to figure out the generation-skipping transfer tax and all of its implications. So, I think that would be important.

I can tell you, as a private practitioner—and I represent entrepreneurs and high-wealth individuals—that if the estate tax is repealed, then we will spend more time than ever, not less time than ever, in planning.

Most of it will be, how do we govern the next seven generations from the grave? Because if we have no estate tax, we have no opening up of assets and we have a retention of assets. How are we going to control the family members who are going to inherit those generations of assets from one to the next?

So I think that planning implications for us are great if you do repeal the estate and gift tax. I think that is something we all have to think about.

I have a long paper, with a lot of considerations in it. Of course, I do not have the time, and you do not have the time for that. So, I really wanted to highlight a couple of items for you.

The first thing I wanted to highlight, is the issue of carry-over of basis. If we move out of a step-up in basis and we move to partially a step-up, one proposal has been to $2.8 million step-up and then the remainder would not be stepped up.

We move into an extraordinary situation where we have a recordkeeping and record retention that must go on for generations, potentially centuries, as people continue to pass assets from one generation to the next with no step-up in basis.

I have tried to give you an example of this in my paper on page 7. But just imagine a family that passes $10 million of assets down to grandchildren, who then in turn spread it among five grandchildren, and spread again, the decades that we would have to hold onto those records that we need.

I referred to what I called the Four Horsemen of the Carry-Over Basis Apocalypse. That would be, one, tracing basis, which historically has been difficult. Our Internal Revenue Code and our regulations under the Internal Revenue Code point that out right now.

Number two, tracing the dates of acquisition of multiple assets. Think about dividend reinvestment plans. Think about mark-to-market on your mutual funds. Think about stock mergers and stock spin-offs.

The third, would be recordkeeping and retention. I think that we would not have enough time or money to reforest everything that would be torn down to retain paper records from decade to decade.

The fourth, would be reporting requirements. Would you really expect a family to retain records that can only be used against them to show the carry-over basis if we did not have step-up in basis?

I think if you did carry-over of basis you would have to think about the add-ons. If I have a charitable contribution carry-forward and I die and my heirs inherit the asset, do they inherit my charitable contribution carry-forward?

If I have a net operating loss personally and they inherit my assets, do they inherit my net operating losses, which now can go for 20 years with me, but should they go for lifetime after lifetime?

Capital loss carry-forwards, which end at death, would carry forward. Do I now have capital loss carry-backs for people if I inherit assets with carry-over basis?

I think what we need to do, is understand that going to a repeal with carry-over of basis does not simplify the law. It complicates the income tax laws that we have.

We need to know when there is going to be a sale or disposition. Death cannot be a disposition. Moving into an irrevocable trust from a revocable trust cannot be a disposition, nor should moving out of a trust or out of an estate to a beneficiary be a disposition. It should only be when the asset is sold or disposed of.

Then I would raise with you, in my last few seconds, if we have all of these people who are doing everything today to deal with the estate tax and we only have about 1 percent to 2 percent who are subject to the estate tax, what about everything that is being done today to avoid income tax? What about all the purveyors of tax shelters that are going on?

What about the grandchild who moves abroad who has no assets and expatriates when he or she has no assets, but then inherits from the grandparent and he or she can then move the assets abroad with absolutely no implications?

I have given you what I think is a seven-point program that would move you to a fair and equitable solution for everyone.

All I would ask, is if you do repeal, that if you do have a combined carry-over of basis and step-up of basis, please understand you are going to have more complications in the income tax law and more desirability of people to avoid income tax than you would be by retaining a step-up in basis and a today—not a gradual, but today—immediate move in what I propose is $5 million per person exemption, with a 5 percent annual increase, forgetting CPI or anything else, and just moving there immediately and retaining a step-up in basis.

Thank you.

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

Senator NICKLES. Mr. Tucker, thank you very much.

I apologize to our panelists, because we have a vote that has been going now for a little over 10 minutes. That means we only have about 4 minutes left to vote.

I want to thank our panelists. A couple of comments. One, some of you had some technical suggestions. I was reading some of those last night when I feel asleep. [Laughter.] I want you to know, I did address those.

But they are appreciated. We are working to try and make sure that we solve some of what I say are the technical issues dealing with this.

Also, Mr. Robbins, your comments were well stated, saying once you have a taxable state, right now it is 37 percent, if you moved it up it could be 55 percent. One of the proposals that we passed last year and that we have continued to push is replacing the unified credit with an exemption so the initial taxable estate would be taxed at 18 percent and would gradually work up so you would not have that shock effect. You were suggesting something along that line. We plan on doing that.

We also plan on addressing some of the other things, Professor, that you are bringing to our attention, and Senator Graham has brought to our attention, trying to fix a couple of the glitches to come up with something that is fair, reasonable, and workable as well.

I apologize that we need to vote.

Senator Conrad, did you have something?

Senator CONRAD. Just a final observation.

Mr. Tucker, I am a former tax administrator, as you perhaps know. I agree with everything you said. I believe that repeal of stepped-up basis, as contemplated, creates a nightmare that most people have not contemplated in almost any detail. I believe it would be a profound mistake, one we would regret for a very long time.

So I say to my colleagues—and I hope we are listening carefully—the complexity attached to repeal of stepped-up basis is, for those who have actually been involved in a tax system up close and personal, I think, would just be a disaster.

I do not think we should repeal the estate tax, but I really think repealing stepped-up basis would create a fiasco.

Senator NICKLES. I might clarify, so everyone is aware. The proposal that many of us have been talking about has a stepped-up basis up to 2.8 for individual, and 5.6. You are going to eliminate your 98 percent. So it is only those other people, and they actually keep records on capital gains. They have to pay capital gains. There is some discussion on how long you would have to, and so on.

But my point is, if you can say you are eliminating the tax for 98 percent of the people by increasing the stepped-up basis so no person has a tax increase, which is one of our objectives in this, but also for the paperwork simplification and so on, we do increase the stepped-up basis to 2.8 for individuals, and 5.6 for couples. That would solve a lot of the problem.

Again, to our panelists, thank you all very much for your participation.

The committee is adjourned.

[Whereupon, at 11:56 a.m., the hearing was concluded.]

APPENDIX

Additional Material Submitted for the Record

Prepared Statement of Howard E. Abrams

Chairman Nickles, Senator Breaux, and Members of the Senate Finance Committee: Subcommittee on Taxation and IRS Oversight.

Thank you for inviting me to speak with you today on the issue of the income tax consequences of repeal of the federal estate, gift, and generation-skipping taxes. I am a professor of law at Emory University specializing in the taxation of corporations and partnerships. These comments are my own. However, I undertook this study at the request of The Real Estate Roundtable.

There is broad bipartisan support for repeal of the federal estate and gift taxes. If repeal is forthcoming, though, and a change is not made to the rules governing the basis of property received through the estate of a decedent, repeal of the death taxes will have the effect of exempting substantial unrealized appreciation from all federal taxation, income as well as estate. Accordingly, Congress may seek to preserve taxation of this unrealized appreciation by providing, as to property passing through the estate of a decedent, that the donee will take a carry-over basis in such property, much like a gift is treated under current law rather. In general, such a rule will tax the heirs on the eventual sale of devised property as the decedent would have been taxed had he sold it prior to death; that is, the heirs will step-in-the-shoes of the decedent for income tax purposes.

If the property transferred is encumbered, application of current doctrine to this new regime might impose taxation not when the heirs sell the property but rather when it passes to them from the decedent or from the decedent's estate. Such a result can be easily avoided by enacting language applicable to death-time transfers modeled after current code section 1041, the Code section currently applicable to transfers of property between spouses or ex-spouses. Section 1041, another step-in-the-shoes rule, accomplishes in the context of divorce precisely what a carry-over basis at death rule is intended to accomplish in the context of death-time transfers. The discussion that follows includes a proposal for such statutory language.

A carry-over basis rule can impose substantial hardship on the heirs if devised property is encumbered. Especially in the context of family farms and other real estate holdings, substantial encumbrances are the norm. When such property is transferred in a carry-over basis regime, upon eventual sale of the property the heirs will be required to pay both the lender and the taxes. If the debt is relatively high and the carry-over basis relatively low, it could be the case that these two payments exceed the full value of the property. In such circumstances, the heirs would have in fact received negative value assets. To ensure that the death-time transfer of property does not result in a net detriment to the beneficiaries, either the amount of the gain could be limited or a partial step-up in basis could be provided for certain specified debt. The discussion that follows includes alternative proposed statutory language for reducing the hardships imposed on the heirs in either of these ways.

Thank you.

Attachment.

Implications to Real Estate Owners of Estate Tax Repeal and Carry-Over Basis at Death

HOWARD E. ABRAMS,[1] PROFESSOR OF LAW, EMORY UNIVERSITY

Overview

Any tax lawyer will tell you that the best way to minimize income taxes is to die, though few clients are willing to act on that advice. But even those clients who seek to prove their immortality can take comfort that if they depart, the income tax man may be left behind. For individuals with substantial assets and insubstantial planning, the grim reaper can bring a potentially crippling estate tax liability. But for astute taxpayers who hold appreciated assets until death, gains so far deferred become gains forever exempted.

This favorable outcome results from the step-up basis at death rule.[2] Under our current income tax system, death is not a taxable event,[3] which means that those who die owning appreciated assets are not by the fact of death alone taxed on their accumulated gains. Taxes not visited on the dead, though, would be visited on the survivors were it not for the statutory step-up basis at death.

Thus, if I purchase real estate for $1,000,000 and hold it throughout my life as it appreciates to $5,000,000, I pay no taxes on that appreciation because I have yet to sell or exchange the property. If I continue to hold that property at my death, I will never pay income tax on the $4,000,000 of increased value. Further, my heirs will be treated as if they bought the property for $5,000,000, ensuring that when they sell the property they will pay taxes, if any, only on the increase in value of the property occurring after my death: the $4,000,000 of gain that accrued in my hands is simply untaxed forever. Of course, whether the $4,000,000 of accrued gain escapes the income tax or is captured by it because I sell the property prior to my death, the entire $5,000,000 value of the property will be ensnared by the federal estate tax.

Estate Repeal May Include Carry-Over Basis at Death

President Bush has proposed repeal of the existing federal estate, gift and generation-skipping taxes. By itself, this represents substantial tax reduction benefiting a variety of taxpayers including all those owning assets at death sufficient to generate an estate tax liability; under current law, those are taxpayers with estates of more than $675,000. The current estate tax rates range from 18 percent to 55 percent, with the 55 percent rate applying to estates of $3 million and over. Estates between $10 million and $17,184,000 pay a 5 percent surcharge on amounts in excess of $10 million in order to phase out the benefit of the graduated rates.

There exists broad bipartisan support for repeal of the federal estate and gift taxes not only because repeal represents tax reduction but more generally because of a shared sentiment that taxing income when it is earned and second time when it is transferred is inappropriate double taxation. In addition, by taxing wealth when it is transferred, the federal estate and gift taxes can impose a tax burden when there are no liquid assets with which to pay the tax liability, forcing a sale of farms and small businesses.

However, political realities suggest that repeal of the estate, gift and generation-skipping taxes likely will bring with it some form of income tax alternative to the step-up basis at death rule. Otherwise, untaxed appreciation would escape estate and income tax entirely. A carry-over basis at death rule would treat my heirs not as if they bought the property for its death-time value of $5,000,000 but rather for the $1,000,000 I actually paid. This carry-over basis rule would mean that my heirs step-in-my-shoes for income tax purposes: when they sell the property, they are taxed on the amount of gain that I would have been taxed on had I sold it during life. As a result, if the sale proceeds amount to $5,000,000, the taxable gain will be $4,000,000.

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[1] Mr. Abrams has been a professor of law at Emory University since 1983 and has taught at Cornell Law School, the University of Oklahoma School of Law, the University of Georgia School of Law, and at Leiden University in the Netherlands. He is the author of four books on the taxation of corporations and partnerships, and his articles have appeared in the Harvard Law Review, New York University's Tax Law Review, the Virginia Tax Review, and other periodicals. Mr. Abrams is a regular speaker at the American Bar Association's Tax Section: Committee on Real Estate meetings, New York University's Institute on Federal Taxation, the AICPA National Real Estate Conference, and similar events. Mr. Abrams spent the 1999–2000 academic year with the national office of Deloitte & Touche, LLP, as the Director of Real Estate Tax Knowledge.

[2] *See* §1014(a)(1).

[3] *E.g.*, Rev. Rul. 73–183, 1973–1 C.B. 364.

The step-up basis rule likely will be repealed only in part, with some limited step-up continuing to be available. For example, the Kyl-Breaux bill (S. 275) proposes a $2,800,000 step-up cap; other limits, both lesser and greater, have been suggested. Under the Kyl-Breaux bill, for example, if I die holding a piece of real estate with a basis of $1,000,000 and a value of $5,000,000 at my death, my heirs would take a basis in this property of as much as $3,800,000,[4] leaving the heirs with a taxable gain of as little as $1,200,000.

Ensuring Death is Not a Recognition Event

For decedents whose estate consists exclusively of cash and unappreciated property, estate tax repeal is pure tax reduction and the basis rule is irrelevant. Indeed, for taxpayers leaving large estates with significant basis, the trade-off of carry-over basis in exchange for estate tax repeal will be favorable. Even for taxpayers with moderate estates comprised of low-basis assets, the trade-off can be positive. For example, consider the case of a taxpayer who dies leaving a single piece of real estate valued at $5,000,000 and having an adjusted basis of $1,000,000. Under current law, the estate tax burden should be about $2,169,450.[5] If the estate tax is repealed and in exchange the heirs are forced to take a carry-over basis in the property, the income tax burden on a subsequent sale will amount to $800,000 if the gain qualifies as long-term capital gain (or more if the property is subject to the 25% depreciation recapture capital gain rate). Thus, estate tax repeal saves $1,369,450 in federal taxes even with the carry-over basis change. Of course, carry-over basis will also force the taxpayer to recognize gain for state income tax purposes (in those states having an income tax), so that the effective rate of taxation on the gain might be somewhat larger.

If the property is encumbered, though, repeal of the estate tax coupled with carry-over basis can be much worse for the heirs. Suppose this piece of real estate is encumbered by a nonrecourse debt of $4,500,000, so the decedent's equity is but $500,000. In such circumstances there is no estate tax liability at all under current law because the decedent's taxable estate value is determined net of the debt, and estates less than $675,000 in net value are not subject to estate tax under current law. However, if the heirs were burdened by a carry-over basis, the income tax liability again would be at least $800,000. That is, repeal of the estate tax and imposition of a carry-over basis rule would increase net taxation from $0 to at least $800,000. Even under the Kyl-Breaux partial step-up bill, the heirs would be saddled with an income tax liability of at least $240,000 despite receiving no benefit from the estate tax repeal.

And what is worse, much of that tax liability might be due not when the heirs sell the property but rather at the moment of the decedent's death. To be sure, no one yet is proposing to treat death as taxable event under the income tax. However, if the current step-up basis rule is changed to a carry-over basis rule, death likely will be a taxable event for those who die holding heavily mortgaged property. And while Congress could avoid that result by enacting specific language to the contrary, such a fix might (in limited circumstances) be worse than the cure. To understand why, we must first look at the tax treatment of sales and gifts of mortgaged property under current law.

When property is encumbered by indebtedness in excess of adjusted basis, transfer of the property can result in uncomfortable tax consequences for the transferor. Debt may exceed adjusted basis because the owner has borrowed against unrealized appreciation in the property, because depreciation has been claimed at a rate faster than the mortgage has been paid down, or by a combination of the two. Regardless of the cause, transfer of such excess mortgaged property generally will produce gain to the transferor.[6]

Thus, if a taxpayer owns property with adjusted basis of $1,000,000, current fair market value of $5,000,000, and subject to a nonrecourse debt of $4,500,000, sale of the property for $500,000 cash (subject, of course, to the debt) yields a gain to

[4] Senate bill 275 proposes a partial step-up basis rule limited to $2,800,000 of step-up apportioned over all property gratuitously transferred by the decedent at death and during life (and still held by the donee at the moment of the donor's death). Without knowing the gross unrealized appreciation in all property transferred by the donor, it is impossible to know the precise basis that any particular asset will take in the hands of the donee under the terms of this bill.

[5] The estate tax liability on $5,000,000 is $2,390,000 less the current credit of $220,550, for a net estate tax liability for $2,169,450. This liability might be reduced if the decedent devised some of the property to charity or to a surviving spouse; it could be greater if the decedent made significant life-time transfers.

[6] *See generally* New York County Lawyers' Assn., Committee on Taxation, *Excess Mortgaged Property*—Caveat Venditor: *A Report on Some of the Consequences of the Carryover Basis Rules on Inherited Excess Mortgaged Property*, 33 TAX. L. REV. 139 (1977).

the seller of $4,000,000 because, for computing the seller's gain, both the actual cash received as well as the debt transferred are treated as sales proceeds.[7] This taxation is appropriate because the seller has pocketed not only the $500,000 cash received at closing but also the $4,500,000 received previously as loan proceeds, loan proceeds that were not taxable when received and which will no longer have to be repaid because the debt has been transferred along with the property.

Essentially the same analysis applies if the owner makes a gift of the property rather than selling it. To be sure, if the property is gifted rather than sold the owner will not receive any cash at closing. Equally true, though, is that the owner received $4,500,000 tax-free when the loan was taken out, and because the loan again goes with the property, those tax-free proceeds will not have to be repaid by the donor. As a result, the law is clear that if property is gifted having adjusted basis of $1,000,000 and subject to a nonrecourse debt[8] of $4,500,000, the donor must recognize income of $3,500,000, that being the excess of the loan proceeds over the donor's adjusted basis in the property.[9]

Because the donor is taxed on some of the accrued appreciation, the donee's basis must be adjusted upward to ensure that this appreciation will not be taxed a second time. Despite the general carry-over basis rule for gifted property, the regulations properly provide that the donee may increase his basis for any gain recognized by the donor on the transfer.[10] Thus, in this example the donee will take a basis of $4,500,000 in the property, so that if the donee eventually sells the property for $5,000,000, there will be only $500,000 further gain to be recognized.

If the current step-up basis rule at death is changed to a carry-over basis rule, the taxation of death-time transfers becomes virtually identical to that of gifts. And because we know that gifts of heavily mortgaged property are taxable to the donor when the gift is made,[11] presumably the same rule would be applied to transfers at death. Thus, a carry-over basis rule at death not only preserves substantial gain not taxed under current law but likely accelerates taxation of that gain to the moment of the decedent's death.

In the context of death-time transfers under a carry-over basis regime, it might be the case that transfer from decedent to executor is ignored and that the recognition event for heavily mortgaged property does not occur until transfer from the executor to the ultimate beneficiary. This does not solve the problem of accelerating recognition but merely postpones it slightly. Indeed, in some jurisdictions real property is not treated as passing through the executor's hands; rather, title is treated as flowing directly from decedent to beneficiary, and in such cases the recognition event would have to be the time of death. In the following discussion when I refer to taxation at the time of a decedent's death, it should be understood that this reference includes the possibility that such taxation might not occur until the property passes through the hands of the executor.

Death as a recognition event would also arise, if property is not given a full step-up in basis at death, upon the death of a partner having a negative capital account. For example, suppose four individuals contribute $100,000 to a partnership, and the partnership uses its $400,000 of equity plus a loan of $1,600,000 to purchase improved real estate for $2,000,000. After 10 years, the partnership has claimed depreciation of about $800,000, so the partnership's adjusted basis in its property equals $1,200,000. The outstanding balance on the loan is about $1,400,000 (assuming a 30-year amortization schedule), which means that each partner's capital account is negative by about $50,000.

Current law's step-up basis at death ensures there is no taxation to a partner who dies at this point, and his share of appreciation in the partnership assets escapes income taxation, now and forever. But if Congress enacts a carry-over basis at death rule, the partner who dies presumably will be taxed at once on a gain of about $50,000.[12] And this taxation is imposed independent of the current value of the property. This problem of negative capital accounts is especially likely to arise in

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[7] *Commissioner v. Tufts*, 461 U.S. 300 (1983).

[8] If the debt is with recourse, then the loan will have to be repaid by the estate prior to the transfer to any heir, either forcing the taxable sale of the property or consuming other assets of the estate so that the property can be passed on unencumbered.

[9] *Levine v. Commissioner*, 634 F.2d 12 (2d Cir. 1980); *see Diedrich v. Commissioner*, 457 U.S. 191 (1982). If the gift is to a charitable organization, the taxation is even greater by reason of §1011(b). *Ebben v. Commissioner*, 783 F.2d 906 (9th Cir. 1986).

[10] Treas. Reg. §1.1015–4(a) (1972).

[11] See sources cited at note 9 above.

[12] Upon the sale or exchange of a partnership interest, the transferor partner's share of liabilities are treated as part of the amount realized. Treas. Reg. §1.752–1(h).

connection with highly-leveraged real estate contributed to an umbrella partnership as part of an UPREIT roll-up.

Congress could, of course, carefully specify that death-time transfers will not be taxable to the decedent even if the property is encumbered. Such language would ensure that if I die holding property with value of $1,000,000, adjusted basis of $100,000, and subject to a nonrecourse debt of $850,000, I would not be taxed on the death-time transfer.[13] Indeed, since my estate may have no liquid assets with which to pay a substantial income tax liability, failing to prevent acceleration of the gain risks forcing an immediate and distressed sale of assets by the estate.

Unfortunately, no current legislative proposal actually includes language to ensure this result. If such language were included, however, it would then be the case that whoever inherited the property would receive a basis of only $1,000,000, precisely the result that a carry-over basis regime presumably intends. To accomplish this result, Congress should amend section 1014 as follows:

§1014. Property acquired from a decedent [carry-over basis]

(a) **In general.**—In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and
2. The basis of such property in the hands of the person acquiring it from the decedent shall be the basis of such property in the hands of the decedent immediately prior to death.

(b) **Property acquired from the decedent.—**

[no change to existing law]

Highly Mortgaged Property Can Be Underwater to the Heirs

But now consider the hapless beneficiary who has just inherited property with current value of $5,000,000, carry-over basis of $1,000,000, and subject to a debt of $4,500,000. This inheritance may not be quite so good as getting the property free and clear, but the equity of $500,000 is still real money. Or so it seems.

If the property is sold for its current value of $5,000,000, the loan must be paid off before the new owner is entitled to keep any of the proceeds. Thus, of the $5,000,000 received for the property, $4,500,000 must be given to the lender, leaving the new owner with only the equity value of $500,000. That would still be a good day's work were it not for the pesky carry-over basis rule; because the new owner's basis in the property was carried over from the decedent, the sale is taxable to the tune of $800,000.[14] As a result, the new owner now not only owes the bank $4,500,000 but the IRS some $800,000 as well, so that the inheritance of $500,000 in equity is in reality worth negative $300,000. Well advised individuals might know to reject an underwater bequest, but who without a tax lawyer in the family would suspect that receiving property with $500,000 in equity puts you out-of-pocket by $300,000 or more?

Not all highly mortgaged property will be underwater in the sense that a sale yields proceeds insufficient to both pay of the mortgage holder and pay the income taxes on the gain. For example, property with current value of $5,000,000, adjusted basis of $1,000,000, and encumbered by a debt of $3,000,000 offers net value to a donee who takes this property with a carry-over basis. Assuming capital gains are subject to a total federal and state tax burden of 25%, our donee can sell the property for $5,000,000, pay off the debt of $3,000,000 as well as the tax burden of $1,000,000, and still have $1,000,000 in hand. Heavily mortgaged property will only be underwater if the amount of the outstanding encumbrance plus the tax burden on the unrealized appreciation exceeds the value of the property.

What should Congress do? Under current law, this problem is solved by the step-up basis rule at death by eliminating the income tax liability. A carry-over basis rule, though, leaves the income tax liability intact, which means someone—decedent, heirs, or a combination of the two—must both pay off the loan and pay off the taxes.

Current legislative proposals include only a partial repeal of the step-up basis at death rule. The Kyl-Breaux bill (S. 275), for example, eliminates current death taxes yet retains the step-up basis rule to the extent of $2,800,000 in unrealized appreciation. It thus provides complete tax relief for individuals whose assets at death in-

[13] This is how property is treated when transferred between spouses or between ex-spouses incident to divorce. *See* §1041.

[14] Sale for $5,000,000 with a carry-over basis of $1,000,000 yields a taxable gain of $4,000,000. Taxed at the lowest income tax rate applicable to long-term capital gain produces a tax liability of $800,000. State taxes would add to this amount.

clude appreciation of $2,800,000 or less, regardless of any encumbrance. For an individual who dies owning property with value of, say, $10,000,000 subject to a debt of $9,000,000 and with adjusted basis of $500,000, this relief will be partial at best even though the net value of the estate is well under the $2,800,000 amount. That is, there will still be taxable gain of $6,700,000 (value of $10,000,000 less carryover basis of $500,000 plus step-up basis of $2,800,000), of which most presumably will be imposed on the decedent at death (gain at death presumably will equal outstanding loan amount of $9,000,000 less total basis of $3,300,000, or $5,700,000 of taxable gain).

Imposing a heavy tax burden on the decedent both accelerates the tax liability and imposes it at a time when there may be no funds with which to pay the taxes. Letting the decedent escape taxation shifts that burden to the heirs who, when they sell the property, will end up with far less than the equity they anticipate. Indeed, they might even end up out-of-pocket.

The most direct solution to this dilemma would be to defer taxation of the unrealized gains until the heirs sell the property—that is, provide by statute that no gain is recognized on the devise of encumbered property—and then limit the tax liability to ensure that the heirs are not out of pocket by reason of the inheritance. Putting such a limitation into law would require something like the following:

§1014. Property acquired from a decedent [gain limitation]

(a) **In general.**—In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and
2. The basis of such property in the hands of the person acquiring it from the decedent shall be the basis of such property in the hands of the decedent immediately prior to death [possible including a partial step-up].
3. Upon the disposition of such property by the person acquiring it from the decedent, any gain recognized shall not exceed the value of the property less the amount of debt encumbering such property at the time it was acquired from the decedent times the highest tax rate applicable to net capital gain.

(b) **Property acquired from the decedent.—**

[no change to existing law]

Alternatively, Congress could eliminate the problem entirely by providing that (1) the decedent is not taxed on the death-time transfer of property even if encumbered and (2) the heirs get a step-up for the amount of any encumbrance existing at the time of the debt. This would avoid the problems indicated above, but it would do so only by bringing back—at least in part—the step-up basis rule.

An astute taxpayer who owned appreciated assets could exploit such a rule by borrowing against low-basis property shortly prior to death. For example, suppose T owns land with adjusted basis of $0 and current value of $10,000,000. Under a carry-over basis at death regime, someone—decedent or heir—is supposed to be taxable on the $10,000,000 appreciation when the property is sold. Yet, if property transferred at death qualifies for a step-up basis at death to the extent of any encumbrance on the property, T should borrow as much as possible against the property immediately before dying.

For example, suppose T places a $9,000,000 mortgage on the property prior to death and then devises both the encumbered land and the $9,000,000 loan proceeds to his child. Child takes the property with a basis of $9,000,000 rather than $0 if a step-up is provided for the debt. However, Child can use the cash to retire the debt and thereby own the land free and clear. By running the debt through the decedent's estate, the carry-over basis rule has been almost entirely avoided.

This tax avoidance technique could be eliminated by providing a step-up basis only for old and cold debt; that is, for debt placed on the property more than one, two or even three years prior to the death-time transfer. Careful taxpayers could still exploit this rule by borrowing early enough, but in such circumstances the loan likely would have some business legitimacy because interest would have been paid for months or years. Nevertheless, probably the best way to limit gain recognition on heavily mortgaged assets without opening the door to wholesale tax avoidance is to provide for a basis step-up only as to excess qualified nonrecourse financing (within the meaning of δ465(b)(6)(B)). By incorporating the definition of "qualified nonrecourse financing," the partial step-up is targeted to real estate activities and excludes the potential abuse areas of related party debt and seller financing. And by further limited the partial step-up to excess debt (that is, a step-up for such debt only to the extent it exceeds adjusted basis), the step-up will be limited to those cases in which the basis is low and the gain to the heirs will be substantial; that is, to cases in which the property's equity may not be sufficient to cover the eventual tax liability. To enact this result, Congress should enact language such as:

§1014. Property acquired from a decedent [debt step-up]

(c) **In general.**—In the case of property acquired from a decedent within the meaning of subsection (b)—

1. No gain or loss shall be recognized by the decedent or the decedent's estate on such transfer; and
2. The basis of such property in the hands of the person acquiring it from the decedent shall be—
   i. the basis of such property in the hands of the decedent immediately prior to death [possibly increased for a partial step-up], plus
   ii. the amount of any qualified nonrecourse financing as described in §465(b)(6)(B) to the extent the amount of such debt exceeds the adjusted basis of such property determined under subparagraph (i).

(d) **Property acquired from the decedent.—**

[no change to existing law]

Conclusion

Repeal of the estate tax is not intended to be fundamental income tax reform. Yet, if a carry-over basis rule at death replaces the current step-up basis rule, the death-time transfer of encumbered property might well include not only a new and substantial income tax liability but also an acceleration of that liability to the moment of death. Carefully drafted language can avoid that acceleration. In addition, a tailored step-up for qualified nonrecourse financing can ensure that heavily mortgaged real estate will not be a negative value asset in the hands of a decedent's heirs.

PREPARED STATEMENT OF K.L. BLISS

Chairman Nickles and Distinguished Members of the Senate Finance Committee:

On behalf of the National Cattlemen's Beef Association (NCBA), which is the trade association of America's cattle farmers and ranchers, and the marketing organization for the largest segment of the nation's food and fiber industry, thank you for your interest in my comments regarding the burden that the death tax places on hard-working American families. I appreciate the opportunity to share with you the devastating affect death taxes have on the ability of cattlemen and women to pass their family businesses on to the next generation.

I am a rancher from Sand Springs, Montana, a small community about 160 miles northeast of Billings. My family has ranched in Montana since the early days of the 1900s. I am a member of the National Cattlemen's Beef Association, the Montana Stockgrower's Association and the Public Lands Council.

For the past several Congresses, relieving the death tax burden has been a top priority for NCBA. We commend the Committee's hard work in making significant progress toward the ultimate goal of eliminating death as a taxable event from the federal tax code. Through our own resources and as a member of the Family Business Estate Tax Coalition, we are committed to working with you and the Committee to making repeal of death taxes a reality. This hearing is evidence that repeal of death taxes remains a top priority for many Members of Congress.

From the cattle industry's perspective, the death tax is the primary obstacle in keeping our family-owned businesses intact and viable during the transition from one generation to the next. Nearly one-half of our members have been in business more than 50 years and 15 percent of our members have operated their family business for more than 100 years. These are the folks who for generations have contributed to the economy of the local communities, and who are the foundation of an industry that represents 20 percent of the U.S. agricultural gross domestic product (GDP).

The agricultural GDP annually generates over $150 billion in local and national economic activity. When you add the high level of economic activity from the public monies generated, such as fuel taxes, property taxes, excise taxes, income taxes and related revenues, one must question the wisdom of a federal policy that effectively erodes the base of the rural economy.

I pay over $20,000 in real estate taxes and $3,600 in personal property tax each year. Other taxes, such as state and federal income taxes vary greatly because, as a rancher, I do not control the price I receive for my product or what is paid for goods and services.

My grandfather came to Montana in the late 1800's and homesteaded near Broadus, Montana. He passed away in the 1940s and my grandmother eventually sold that ranch to help my parents purchase the ranch that my wife, Cheryle, and I operate, along with my son, Matt, and his family today. My family has operated this ranch since 1955, and I am proud to be a third generation Montana rancher.

My parents were determined that my brother and I would get an education. That meant I would be going to college and my mother would have to move to town so that my brother could attend high school. My father could not operate the ranch alone, so my parents chose to move to Missoula, Montana where we could both attend school. They leased out our ranch and sold all of the livestock in 1968 so that we could continue our education.

In 1973, when I finished college, my brother and I moved back to the ranch, and we purchased livestock and equipment to begin ranching again. In order to undertake this venture, we had to go into debt. Also, during this time, my mother and father were going through divorce proceedings. To pass on part of the ranch and to reduce the size of the estate, their agreement stipulated that my father's half of the ranch be split between my brother and myself.

My brother was killed in a crop spraying accident on our ranch in 1980. As a result of his death, his property, and his one-fourth of the ranch went back to my mother. At that time, my mother was assessed a state death tax of $5,891 on my brother's one-fourth, even though my father used the unified credit to gift his part of the ranch. By then, she had decided to move back to the ranch and had sold the Missoula home, and invested the proceeds into stocks.

In 1981, to consolidate assets, my family Bliss Livestock Corporation. My mother, father and I contributed land and other assets and each party owned 70 percent, 21 percent, and 9 percent respectively. My mother's share included the property she had inherited from my brother.

I managed the entire operation after my brother's death in 1980 and accumulated debt to fund growth. During the mid-eighties, my mother started gifting to me Bliss Livestock Corporation, in order to decrease the value of her estate. My mother had lived through the "Great Depression" and it was very difficult to convince her of the necessity of more extensive estate planning. My lawyers, accountants and I continued to urge her to do more, but her Depression ear experience was worth more to her than any advice regarding the future. Given her reluctance to reduce the size of her estate, in 1991, I purchased a $200,000 life insurance policy on her that cost me $81,800 over four years.

My mother and father both passed away in 1998 and I inherited their share of Bliss Livestock Corporation, as well as a $92,000 federal death tax bill and a $29,000 state death tax. Because we had used the unified credit in my brother's passing, the amount of unified credit that could be used toward the death tax when my parents passed away was decreased, making this death tax bill larger than it otherwise would have been.

On the positive side, just prior to my parent's passing, Congress had created a special family business exemption. Had that not occurred, my death tax would have been in excess of $425,000 and I would have been forced to liquidate the assets that my family depends upon for a living.

Ranching is a debt intensive business. Over the years I have been indebted to fund short-term obligations to operate on a daily basis, and long-term to buy property and equipment. I have averaged about $650,000 in long-term debt, not including taxes, to fund the operation. I currently have roughly $400,000 in long-term debt and a $140,000 short term debt that I am paying on annually.

Debt has to be repaid out of operating income from farming and ranching revenue. When crop prices are low, as they have been for the past several years, and calf prices are low like they were in the 90s, it is difficult to make an operation cash flow. For the next thirteen years, I will be paying off the death tax debt. Add in my operating debt payments, income taxes, and high operating costs, it becomes difficult to stay in business.

To create an economically viable operation, I have tried to do all the right things. I have grown the business, invested wisely and increased the value of my operation by making improvements. I have also initiated environmental stewardship projects that improve water quality, wildlife habitat and pasture management. Notable organizations and institutions have recognized our innovation and hard work such as our ranch being featured in the Winter Grazing Success booklet, and as a host ranch for the Governor's Range Tour in Montana.

We are currently working on a 26 mile water pipe line, on mostly federal land, to improve range conditions by providing additional water sources for cattle and wildlife. This project cost us over $70,000 last year and we will have to spend another $40,000 to complete it this year. Most of this money is borrowed so we will be several years paying back the loan. I believe that environmental stewardship is one of the most important things we do as ranchers, and we want to pass on the ranch to the next generation in better shape than we received it. The money for everything we do in this regard comes from the family ranch.

Everytime we have made a profit, we have reinvested it back into the ranch to improve or expand our operation, but a tax of $92,000 is a lot to take from a family business. If my wife Cheryle and I were to die right now, I don't believe we would be able to leave our ranch to my son Matt and his family.

My wife and I were able to expand in the 90's and currently our estate is worth $7 million. With the present death tax, my son would have to pay $1.5 to $2 million to the federal government and a significant amount to the state of Montana. In order to pay the tax he would need to sell a large portion of the ranch. This would leave him a ranch that is less efficient and less economically viable.

I have been gifting shares to my son, but at the current non-taxable gift level it could take up to 700 years to gift the entire estate to him. Life insurance is an option, but a $1.5 million policy is cost-prohibitive given the payments I must make on the current death tax and my operating debt. Even if my son could arrange to pay a $2 million death tax bill over 10 years, he would still owe over $200,000 a year plus interest. A ranch like ours just does not generate that much cash flow.

Ranches the size of ours are the lifeblood of small rural communities. We are large enough to provide jobs, and purchase large amounts of goods and services that support main street businesses. Death tax not only takes money out of the pockets of hard working ranch families: it is also money that I can't invest in my business or use to support my rural community.

I started working this ranch at six years old driving a tractor in the hay field. The assets I received from my parents were not a windfall. I operated the ranch for 25 years before they died, and took a great deal of financial risk that almost cost us the ranch in the early 1980's. I started in 1973 with an old house and a couple of old wooden sheds and with years of hard work and good management, our ranch today is one of the most productive and improved ranches in the county. Hard work should be rewarded, not penalized by a death tax.

Our ranch is more than just a business or a home; it is a lifetime commitment by past, present and future generations. We have worked hard all our life on this ranch, and at some point we'd like to be able to do more than buy fence posts and insurance policies. This is my reality, but could become my son's nightmare if the death tax is not eliminated.

Some would have you believe that only the richest 1 or 2 percent ever pay death taxes. My wife sure doesn't feel rich; she still has the same old carpet that was put in the house in 1976.

Death is a certainty for each of us. Unfortunately, it also unleashes the IRS, which can take up to 55 percent of a business and its assets before the next generation has the opportunity to carry on the family tradition. Statistics indicate the average age of a cattleman is 55 years, which suggests there currently are a lot of ranch families who will soon face the burden of federal death taxation. Statistics also indicate that the number of cattle operations has declined 20 percent since 1981, a trend that many feel is accelerated by the burden death taxes pose on surviving family members.

NCBA feels this burden has contributed to families selling their family farming and ranching enterprises in anticipation of the death tax. In addition, many of our members report that their efforts to plan for the impact of death taxes has led to management decisions that are not always in the best interests of operating a profitable enterprise.

We also believe, in addition to enhancing the well-being of the beef industry, that death tax reform will provide society in general with environmental benefits. Any business that is successful over a long period of time is one in which the principals pay close attention to the maintenance, up-keep and improvement of the production facility. For cattlemen, their production facility is the land—land that they and their ancestors have nurtured to ensure its ability to support their beef herds, and land that they share with a natural ecosystem that includes wildlife habitat, watersheds, and riparian areas.

A cattle operation is a capital-intensive enterprise typified by having most of its assets invested in the land or cattle. In the event of the death of a principal family member, the sale of the land and/or cattle becomes the primary source of funds available to meet the costs of death taxes. When this occurs, ranches or farms get split up, particularly in areas of aggressive urban/suburban growth and escalating land values. The net result is that land that once provided nutritious beef or other staples for our diets and habitat for Mother Nature's flora and fauna is instead used to grow houses, shopping malls, and roads.

Taxing capital at death is frustrating when one considers that the money used to buy, maintain and improve these assets was taxed when earned. Adding to the insult are the death tax rates which can impose a top rate of 55 percent—which is especially troubling when compared to the top capital gains tax rate for individuals of 20 percent.

NCBA is a member of the Family Business Estate Tax Coalition, a large group made up of trade associations and organizations representing the vast majority of this nation's family owned enterprises. This group has worked in a bipartisan fashion to build the case of the negative impact that the death tax places on family businesses. The message of the Coalition is simple, and perhaps redundant, but it needs to be repeated.

Liquidity is the fundamental characteristic that distinguishes the estates of family owned businesses from those of individuals holding marketable securities and/or other liquid assets. Publicly traded stock can be sold to pay the death tax, doing little harm to capital investments that are critical to the productivity of the business and the overall financial well-being of a company. But a family-owned business, whether it's a ranching operation or a restaurant, must sell critical assets—and often the business itself must be sold—to pay death taxes, or suffer under the resultant debt load necessary to continue in business.

Our campaign to repeal the death tax is about jobs, economic growth and the financial stability of this nation's small and medium sized communities. On behalf of the NCBA, we thank you and your colleagues for holding this hearing. We encourage you to move boldly in your efforts to provide relief from the burden of the death tax.

Thank you Mr. Chairman for the opportunity to visit with you and the Senate Finance Committee today. I look forward to further discussion on the death tax which has such negative consequences on family businesses and rural communities. I will be happy to answer any questions you or the Committee may have.

PREPARED STATEMENT OF WILLIAM H. GATES, SR.

Mr. Chairman and Members of the Subcommittee on Taxation and IRS Oversight:

My name is William H. Gates, Sr. I live in Seattle, Washington having been a resident of the Seattle area all of my life. I am 75 and have been engaged in the private practice of law in Seattle for 48 years. I am a graduate of the University of Washington and of the University of Washington Law School. I am representing Responsible Wealth, a national association of business leaders and investors concerned about economic inequality in America.

There is a misconception about who the over 700 individuals are who have signed the Call to Preserve the Estate Tax. We do have super-wealthy individuals like George Soros, Ted Turner, Julian Robertson, and Paul Brainerd who have signed on. But the majority of the signers are like the individuals who are testifying before this panel. They are the "millionaires next door," as described in the recent book by Thomas Stanley and William Danko, those with wealth between one and ten million dollars. Many of the signers have family enterprises and will pay estate taxes. And yet they believe it would be bad for our country to completely repeal it.

I believe, with Theodore Roosevelt, Louis Brandeis, Herbert Hoover and scores of other wise observers in the early 1900s that it is not in the interest of this country to have large fortunes passed from generation to generation forming ever larger pools of money and accretion of power. While the estate tax does not completely prevent such transfer it does make serious inroads on what would, without it, be an ever increasing, inexorable build up of a larger and larger pool of money.

While we may not be able to insure that all children start their lives on a level playing field, that is something we should strive for and the estate tax does keep us closer to that ideal. A good life should be something which is achieved. It should not be delivered as a result of the womb you happened to start out from.

I think the estate tax is an appropriate tax and I accept it, as I do federal income taxes, as the price of living in the United States and being a U.S. citizen. It is appropriate that a special tax be imposed on those who have so very fully enjoyed the benefit of the things this country provides: schooling, order, freedom and encouragement to succeed and models of success. In a very practical sense, the wealth one accumulates derives as much from the environment which this grand nation makes available and it is perfectly appropriate that the cost of its maintenance be paid back in proportion to what has been extracted.

In the present setting when new tax packages are being designed it seems to me particularly bad policy to subtract from the necessary revenue the sums produced by the estate tax when those dollars are going to have come from somewhere else—

someone else. It is perfectly clear that that someone else will be a citizen with much less ability to pay than the heirs of our wealthiest people. Let me add here that I am doubtful that the true fiscal impact of repeal has been accurately projected. Revenues from this tax will grow dramatically in the future. The personal wealth that has been created in this country in the last 10 or 20 years is immense and will be reflected in sharply increased estate tax revenues.

I understand that the purpose of this hearing is to consider the merits of the estate tax and whether it should be reformed or repealed. I don't think the Committee can make an informed decision on that issue without considering the impact of the estate tax on other activities, such as charitable giving. As co-chairman of the nation's largest charitable foundation, I believe that repeal of estate tax will be harmful to our charitable institutions and vital civic sector. I believe Americans are generous people—and are motivated to give to charity by concerns other than the tax code. But the estate tax is a powerful incentive for charitable giving, particularly among households with estates valued over $20 million. I do not think we know what the full consequences of wholesale repeal will be on our nation's hospitals, universities, land conservancies and private charities.

There was a hearing yesterday before the Senate Finance Committee on encouraging charitable giving. I understand that one fundamental premise of that hearing was that making charitable contributions tax deductible for non-itemizers would encourage charitable giving. I don't see how one could distinguish the type of encouragement underlying that hearing from the type of encouragement provided by the estate tax. The biggest difference is, I believe, that the taxpayers affected by the estate tax typically have far more to give than taxpayers that do not itemize their deductions for federal income tax purposes. What is good for the income tax must certainly be good for the estate tax.

People oppose the estate tax claiming it is "not fair." Each tax that we have will elicit those who feel this way. But I ask "Fair compared to what?" Is it unfair to tax the accumulated wealth of the richest 1% of households, much of which is in the form of unappreciated capital gains that have never been taxed? Is it more fair to tax the wages of low wage workers trying to survive today? Is it fairer than a sales tax or property tax? I accept that we must have taxation—and that within the spectrum of taxes—the estate tax is among the most fair.

I do not deny that there are some few situations where the application of the estate tax leads to a result which is undesirable. An example would be the rare case where a second or third generation is prevented from continuing a family business because of the requirement to pay a tax on that asset. There are special provisions in the tax code aimed to avoid this result and these work in lots and lots of cases. If they do not go far enough, surely the ingenuity of our tax experts can expand these areas of relief to encompass even more cases.

A month ago, when Responsible Wealth issued the "Call to Preserve the Estate Tax," the conventional wisdom was that the estate tax would be completely repealed. I am here to advocate for reform of the estate tax—but not wholesale repeal.

I believe that the original intent of the estate tax—to be a dynasty tax—should be preserved and strengthened. We should have a tax that falls primarily on the vast transfer of financial assets. Fix it, don't repeal it.

Thank you for the opportunity to appear before this panel.

Table 1
Early Federal Estate Taxes 1797 to 1915

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

Early Federal Estate Taxes 1797 to 1915

Legislation/Court Rulings	Description	Purpose/Importance
Stamp Act of 1797	Federal stamps required on receipts and discharges from legacies and intestate shares.	To finance undeclared naval war with France
1802	Stamp Act repealed.	
Revenue Act of 1862	Tax on legacies and distributive shares of personal property from estates over $1,000; rates ranged from 0% for surviving spouse bequests to 0.75% for distributions to ancestors, lineal descendants and siblings to 5% for those to distant relations and unrelated persons.	To finance Civil War
Internal Revenue Law of 1864	Added a succession tax, a tax on bequests of real property; increased legacy tax rates on personal property transfers; first gift tax applied to real property transfers of less than adequate consideration made during decedent's life. Also introduced an exemption for small estates; special treatment for surviving spouse bequests; tax deductions for bequests to charitable organizations.	To finance Civil War
1870	1864 tax repealed.	
1874 Supreme Court Ruling *(Scholey v. Roe)*	The Court disagreed with the taxpayer's contention that death taxes were direct taxes that must be apportioned according to the census.	Upheld the constitutionality of legacy and succession taxes.
Income Tax Act of 1894	Treated gifts and inheritances as income and taxed them as such.	
1895 Supreme Court Ruling *(Pollock v. Farmers' Loan and Trust Company)*	The Court ruled the Income Tax Act of 1894 unconstitutional because it taxed gains from real estate, thereby constituting a direct tax which had to be apportioned among the states according to the census.	Set the stage for passage of the 16th Amendment to the Constitution which expressly authorizes the federal government to impose an income tax without census apportionment.
War Revenue Act of 1898	Death tax applied to value of personal property in a gross estate (after a $10,000 exemption) instead of bequests; property going to a surviving spouse excluded from tax; rates graduated from 0.74% to 15%.	To finance the Spanish American War
1900 Supreme Court Ruling *(Knowlton v. Moore)*	The Court reaffirmed its earlier decision that the estate tax was an indirect tax and rejected the contention that death taxes were the exclusive prerogative of the states.	
1902	1898 tax repealed.	

Table 2
Development of Modern Estate Tax, 1916 to 1975

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

Development of Modern Estate Tax, 1916 to 1975

Legislation	Description	Purpose/ Importance
Revenue Act of 1916	Introduced modern estate tax which applied to net estate (gross estate minus deductions); tax rates started at 1% of the first $50,000 of net estate to 10% on estates exceeding $5 million; gross estate included personal and real property, life insurance payable to estate, certain lifetime transfers and transfers which [illegible] affect on or after death; all joint prop[illegible] was included unless there was evidence that the co-owner gave support; deductions allowed for administrative costs, debts, claims, funeral costs and support of decedent's de[illegible]endents during estate's administration.	To help offset revenue shortages caused by reduced U.S. trade tariffs due to World War I.
Revenue Act of 1917	Increased rates and added two brackets; estate tax rates went from 2% on net estates below $50,000, to 22% on net estates between $8 and $10 million, and 25% on those above $10 million. Estates of those who died in military service were not taxed.	To help offset defense costs of World War I.
Revenue Act of 1918	Reduced rates on estates under $1 million; expanded estate tax base by including spouse's dower rights and life insurance proceeds over $40,000; allowed a deduction for charitable contributions.	Compromise in debate between and House and Senate between cutting rates versus replacing estate tax with an inheritance tax.
Revenue Act of 1924	Increased top rate to 40% on estates over $10 million; allowed credit against federal estate taxes for state death tax of up to 25% of federal liability; expanded estate tax base by including revokable transfers; added a gift tax with same rate schedule along with exclusions of $50,000 over lifetime and $500 a year for each donee.	
Revenue Act of 1926	Repealed gift tax; lowered top rate to 20% on estates over $10 million; increased exemption to $100,000; increased the maximum credit for state death taxes to 80% of Federal liability.	Response to stiff opposition toward estate and gift taxes.
1929 Supreme Court Ruling *(Bromley v. McCaughn)*	Court held that gift tax was an excise tax which fell in the category of indirect taxes.	
Revenue Act of 1932	Raised almost every estate tax rate; added two new brackets; dropped estate exemption from $100,000 to $50,000; reintroduced gift tax with rates 75% those of estate taxes; set lifetime gift exclusion at $50,000 and annual exclusion of $5,000 per donee.	To increase federal revenues that had been reduced by the Depression.
Revenue Act of 1934	Raised top estate tax rate to 60% on estates over $10 million.	Extension of social policies that aimed to redistribute income.
Revenue Act of 1935	Raised top estate tax rate to 70% on estates over $50 million; reduced estate and gift lifetime exclusions to $40,000.	Extension of social policies that aimed to redistribute income.
Revenue Act of 1940	Added a 10% surtax to income, estate and gift taxes.	To pay for increased military preparedness as war broke out in Europe.
Revenue Act of 1941	Increase in estate tax rates range from 3% on net estates under $40,000 up to 77% on estates over $10 million.	
Revenue Act of 1942	Created a $60,000 estate tax exemption and gift tax exclusions of $30,000 lifetime and $3,000 annually; expanded estate tax base through inclusion of insurance paid for by decedent; excluded community property from gross estate only to the extent that the surviving spouse could be shown to have contributed.	Tried to correct the perceived inequity between community property and noncommunity property states.
Revenue Act of 1948	Allowed a marital deduction equal to the value of all property passing to a surviving spouse up to a maximum ½ of the adjusted gross estate in noncommunity property states.	Replaced 1942 community property rules that were complex and unsuccessful.
Internal Revenue Code of 1954	Changed estate taxation of life insurance to include most proceeds.	

Table 3
Restructuring Federal Transfer Taxes 1976 to Present

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97, Joint Committee on Taxation, "Summary of Revenue Provisions of H.R. 2014 ("Taxpayer Relief Act of 1997"), August 1, 1997 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

Restructuring Federal Transfer Taxes 1976 to Present

Legislation	Description	Purpose/Importance
Tax Reform Act of 1976	Unified estate and gift tax with one graduated rate of tax and a single estate and gift tax credit; rates were graduated up to 70% on taxable estates over $5 million; the credit was $42,500 (same as $161,000 exemption) for transfers made in 1980 and $46,800 ($175,000) thereafter; added new tax on generation skipping transfers (GST); set up a carryover basis rule for inherited property so that the basis for the heir(s) was the asset's value at the donor's date of death after adjustments; special valuation and payment rules for small businesses and farms; increased marital deduction to ½ adjusted gross estate or $250,000.	Biggest structural change was unification of estate and gift taxes.
Revenue Act of 1978	Suspended the effective date of carryover basis rules until 1980; set up rules so that surviving spouse who "materially participated" in operating a family farm or business could treat some of appreciated value as cash contributed by spouse.	
Crude Oil Windfall Profits Tax Act of 1980	Repealed 1976 carryover basis rules retroactive to effective date.	Added as amendment to tax bill.
Economic Recovery Tax Act of 1981	Increased unified credit to $192,800 ($600,000 exemption); cut the top rate from 70% to 50%, phased in over 3 years, on transfers over $2.5 million; allowed unlimited marital deduction; included only ½ joint property in otherwise fully-valued pension benefits; simplified and liberalized rules on closely held businesses and family farms; increased annual gift exclusion to $10,000; repealed orphan deduction; delayed effective date of GST rules another year.	Changes reduced the number of taxable estates.
Deficit Reduction Act of 1984	Froze top transfer tax rate at 55% until 1988; liberalized rules on estates containing closely held businesses.	To raise revenue for deficit reduction.
Tax Reform Act of 1986	Repealed GST tax retroactive to 6/1/76 and replaced it with a single rate set at the top estate tax rate (then 55%); introduced 50% exclusion for employee stock ownership plans (ESOP)	
Omnibus Budget Reconciliation Act of 1987	Froze top transfer tax rate at 55% until 1993; phased out graduated rates and unified credit for estates over $10 million; closed a perceived loophole whereby an estate could reduce its tax liability through a series of ESOP sales and purchases; "estate freeze" transactions provisions caused the total value of transferred property to be included in gross estate as property in which the decedent retained an interest.	To raise revenue for deficit reduction.
Technical and Miscellaneous Revenue Act of 1988	Removed marital deduction when spouse is not a U.S. citizen unless the transfer uses a qualified domestic trust; expanded and clarified estate freeze rules; amended alternate valuation rules for family farms.	
Revenue Reconciliation of 1989	Amended provisions dealing with GST and noncitizen spouses; dropped ESOP exclusion.	
Omnibus Reconciliation Act of 1990	Retroactively repealed "estate freeze" rules from 1987 and 1988; added new rules regarding whether a transfer constituted a gift.	To raise revenue for deficit reduction.
Omnibus Reconciliation Act of 1993	Restored the top two transfer tax rates to 53% and 55% retroactive to 12/31/92.	To raise revenue for deficit reduction.
Taxpayer Relief Act of 1997	Increased unified credit so that exemption is $625,000 in 1998, rising to $1 million in 2006 and after; lowered estate taxes on closely held businesses and family farms.	First general estate tax relief since 1981.

Prepared Statement of Thomas D. Goodner

Mr. Chairman and members of the committee, my name is Tom Goodner and I am President of Goodner's Supermarkets in Duncan, Oklahoma. I want to thank the chairman and members of the subcommittee for holding this most important hearing on preserving and protecting family business legacies.

I'd like to give you a little background about our family-owned business. My father, Roy D. Goodner, began his career in the retail grocery business in 1937. Our first store was 14'x16', and we lived in back of the store. By 1945, he opened a store in Duncan, Oklahoma. I began my grocery career at the age of 3, helping sack potatoes in my parents' store. Gradually, over time my parents grew the business into a 3-store operation.

In the late 1960s, my father began to experience health problems and transferred some of the ownership interests to my mother. Unexpectedly, in 1971 my mother passed away before my father did, leaving a substantial estate tax liability. We paid the government over $700,000. My father didn't have the cash so we borrowed the money for the federal estate tax payment from our local bank, which took 7 years to repay. During that timeframe, my father became disillusioned by his potential estate tax liability and I gradually proceeded to buy the business interests from him and other family members.

Today our business consists of 5 retail food stores and a restaurant. Currently, my wife, Linda, runs all office functions: accounts payable, accounts receivable, payroll, taxes, etc. My two sons, Rob and Jerry and daughter, Dena, are all actively employed in our family-owned business. Goodner's employs approximately 700 people in our business. As a family business, we are committed to serving the needs of the communities where our stores are located and our associates live and work.

One of the biggest threats to our future viability and growth as a family-owned business is the ominous cloud hanging over our heads—the federal estate tax. In the grocery industry we now compete with multi-billion dollar megachains with significant financial resources. To stay competitive, we must continue to reinvest in our businesses; remodeling older stores and building new ones, and adding services and new technology to better serve our customers. For example, just the equipment in a single, 60,000 square foot store currently costs $3.5 million and the inventory costs are $1.5 million. The cost of the building and parking lot in Oklahoma runs about $3 million. If my family and employees were to experience my untimely death, the family would face substantial estate tax liability. Having to pay the federal government almost 55% of the estate would place a substantial drain on our capital base. It would potentially force us to liquidate assets, jeopardizing the future of our company and continued employment of our loyal associates.

As independent family-owned grocers, we provide diversity in the marketplace, offering consumers and communities competitive choices. Privately-owned retail grocers are facing unprecedented competition from multi-billion dollar megachains and supercenter competitors. In order to compete, family-owned businesses need capital to reinvest in our companies. The death tax takes needed capital from family businesses. Rather than pay the punitive death tax and leverage the company, many family business owners are making the decision to sell. Repeal of the death tax is the only answer to preserving and protecting family business legacies. No exemption or rate reduction can be as effective.

In President Bush's Address to Congress, he said, "It's not fair to tax the same earnings twice—once when you earn them, and again when you die, so we must repeal the death tax." I could not agree more. We pay income taxes, payroll taxes, unemployment taxes, property taxes, and then we pay the death tax. As a true family-owned business, we are not a Ted Turner or a Bill Gates, Sr.

I am here today on behalf of the National Grocers Association (N.G.A.) and the Oklahoma Grocers Association to ask for repeal of this unfair and anti-family tax. The important point for the Finance Committee is to act now in support of estate tax repeal legislation. Privately-owned and operated businesses cannot compete competitively when the federal government makes small business its indentured servant. I urge the Finance Committee members to act now to preserve the future of privately-owned and operated businesses before it's too late.

N.G.A. is the national trade association representing the retail and wholesale grocers that comprise the independent sector of the food distribution industry. An independent retailer is a privately owned or controlled food retail company operating in a variety of formats. Some are publicly traded but with controlling shares held by the family. Most independent operators are serviced by wholesale distributors, while others may be partially or fully self-distributing. Independents are the true 'entrepreneurs' of the grocery industry and dedicated to their customers, associates, and communities. N.G.A. members include retail and wholesale grocers and their state associations, as well as manufacturers and service suppliers. At one time this industry segment accounted for half of all food store sales in the United States. In recent years, however, a number of successful family-run companies have opted to sell because of the economic disincentives caused by the estate tax.

SUMMARY OF POSITION

N.G.A.'s retail and wholesale grocers are the backbone of their communities, whether they operate a single store or a larger community multi-store operation. Repeal of the estate tax is N.G.A.'s number one legislative priority. The death tax deserves to die. It does substantial harm to family business owners, their companies, their employees, their communities and to the economy as a whole. On behalf of the nation's independent retail and wholesale grocers, N.G.A. strongly urges the Senate Finance Committee and the entire Congress to act now to support elimination of the estate tax. Privately owned retail grocers are facing unprecedented competition from multi-billion dollar megachains and supercenter competitors. In order to compete, all businesses need capital to reinvest in their companies. Keeping up with new technology, remodeling and expanding their stores, adding new consumer services, building or buying new stores: all of these business decisions are predicated on having the necessary capital. The federal estate tax of up to 55% on the value of their business upon the death of an owner places them at a significant competitive disadvantage. Instead of using this capital to grow the company, it is earmarked to pay taxes.

This anti-family, anti-business tax policy forces many families to face the prospect of selling, going out of business, and denying the next generation of entrepreneurs the opportunity to take the risks and reap the rewards that this industry offers. A week doesn't go by that we don't hear or read about a successful family-owned grocer selling the business. Successful family-owned businesses are making the decision to sell now and pay the capital gains tax, rather than the punitive, confiscatory estate tax.

LEGISLATIVE PROPOSALS

Congress, last session, voted twice to eliminate the death tax; unfortunately, President Clinton vetoed the legislation. I want to thank the members of the Finance Committee who have voted for or sponsored legislation to eliminate the death tax and for recognizing its importance to every family-owned business—whether retail and wholesale grocers, farmers, restaurant owners, or others. Senate Finance Committee members Jon Kyl (R–AZ) and Senators John Breaux (D–LA), Phil Gramm (R–TX), and Blanche Lincoln (D–AR) have introduced the Estate Tax Elimination Act of 2001 (S.275). Numerous other estate tax elimination proposals have been introduced as well.

The important point for the Finance Committee is to act now is support of estate tax repeal legislation. Privately-owned and operated businesses cannot compete competitively when the federal government makes small business its indentured servant. N.G.A. urges the Finance Committee members to act now to preserve the future of privately-owned and operated businesses before it's too late.

STUDIES CONFIRM THE NEED FOR ESTATE TAX REPEAL

The case for eliminating the estate tax has been studied to death. The Joint Economic Committee (JEC) released its study, *The Economics of the Estate Tax*, concluding that the estate tax generates costs to the taxpayer, the economy and the environment that far exceed any potential benefits. Specifically, the report found the following:

- *The estate tax is a leading cause of dissolution for thousands of family-run businesses. Estate tax planning further diverts resources available for investment and employment.*
- *The estate tax is extremely punitive, with marginal tax rates ranging from 37% to nearly 80% in some instances.*
- *The existence of the estate tax in this century has reduced the stock of capital in the economy by approximately $497 billion, or 3.2%.*
- *The estate tax violates the basic principles of a good tax system: it is complicated, unfair and inefficient.*
- *The distortionary incentives in the estate tax result in the inefficient allocation of resources, discouraging saving and investment, and lowering the after-tax return on investments.*
- *The estate tax raises very little, if any, net revenue for the federal government. The distortionary effects of the estate tax result in losses under the income tax that are roughly the same size as estate tax revenue.*
- *The enormous compliance costs associated with the estate tax are of the same general magnitude as the tax's revenue yield, or about $23 billion in 1998.*

"The Case for Burying the Estate Tax" by Tax Action Analysis, the Tax Policy Arm of the Institute for Policy Innovation, reaffirmed the JEC study, and found that:

"Estate taxes strike families when they are at their most vulnerable: along with the family member, families can lose what the family member built. High marginal tax rates often force heirs to sell family farms or businesses just to pay the estate tax bill. Eliminating the estate tax altogether would eliminate all these complexities and injustices with no revenue loss to the Treasury. In fact, after ten years, eliminating the estate tax would produce sizeable economic gains, actually increasing federal revenues above the current baseline.

Eliminating the federal estate tax in 1999 would cause the economy to grow faster than in the current baseline, mainly due to a more rapid expansion of the U.S. stock of capital, by the year 2010:

- Annual gross domestic product would be $117.3 billion, or 0.9% above the baseline.
- The stock of U.S. capital would be higher by almost $1.5 trillion, or 4.1% above the baseline.
- The economy would have created almost 236,000 more jobs than in the baseline.
- Between 1999 and 2008, the economy would have produced of $700 billion more in GDP than otherwise.

The damage that estate taxes do to capital formation further magnifies the loss to society. Doing away with estate taxes would produce positive economic growth effects large enough to offset most of the static revenue loss.

- Between 1999 and 2008, elimination of the estate tax would cost the Treasury $191.5 billion.
- But the over $700 billion in additional GDP would yield $148.7 billion in higher income, payroll, excise and other federal taxes.
- In other words, higher growth would offset 78% of the static revenue loss over the first ten years.
- By 2006, the dynamic revenue gain from eliminating the estate tax would be enough to offset the annual static revenue loss completely."

More importantly, N.G.A.'s own 1995 study of its family-owned members confirms the real life need for elimination of the federal estate tax. In the event of the owner's death, 56% of the survey respondents said they would have to borrow money, using at least a portion of the business as collateral, and 27% said they would have to sell all or part of the business to pay federal estate taxes. Grocers reported that this would result in the elimination of jobs. These findings were similar to those that were conducted as part of a broader industry-wide study conducted by the Center for the Study of Taxation.

Here is what other real family-owned grocers have to say about the effects of the estate tax:

From a New Jersey retailer: "Estate tax has a negative impact on what should be positive business decisions. Many business owners feel that they cannot expand because they have to pay this tax. Also, Americans should be encouraged to save and invest to plan for their future. With estate tax, the more assets one has with death, the more they have to pay the federal government."

An Alabama grocers stated: "As the only son and heir to our family-owned business, our family lives under the constant fear that we will be forced to sell or liquidate our business upon the death of my parents in order to pay the estate tax. Inasmuch as my father, who is 85 years of age, and my mother who is not far behind, have worked hard to develop a business that could be passed on not only to their immediate family, but as a legacy for their 4 granddaughters. How would we be able to explain to them that all the hard work and dedication that has been put into the business for the past 27 years was only to pay off the federal government because their grandparents passed away."

A Washington retailer writes: "I am a small businessman, a grocer, running 2 small grocery stores in Naselle and Ocean Park, Washington. My wife and I have been operating this business since 1967. Having recently done extensive and expensive financial planning, I know first hand how badly we (our country) need to consider repealing our Death Tax. Without going into great detail, I will tell you this: Hire a financial planner, hire a lawyer, set up trusts and limited partnerships and buy a huge insurance policy and you *may* survive a tax burden that is so huge you would have to close your business and sell your assets in order to pay it. The cost for all of this planning for my small business is approximately $20,000 per year. This seems an extreme about of money. Money that could be going to capital improvements, extra labor dollars, etc., etc."

An Oregon retailer states: "My grocery business was founded by my parents 64 years ago. I am the second generation in the family business. My son hopes to carry the business to the fourth generation. This is highly questionable with death taxes at 55%. If it has to be sold to satisfy the government for the unfair and excessive tax, then another small independent business is gone, along with the jobs my stores offer to this community."

CONCLUSION

Numerous studies exist that reinforce the need for elimination of the estate tax. Now is the time for Congress to act. Privately-owned and operated retail grocers, as well as other community businesses, face unprecedented competition and need capital in order to compete with multi-billion dollar megachains and supercenters such as Wal*Mart. The federal estate tax robs privately-owned entrepreneurs of the necessary capital needed to maintain their competitive position in the marketplace with multi-billion dollar public companies. Failure to act now places the competitive diversity of our free enterprise system in serious jeopardy. On behalf of N.G.A. members and family-owned companies across the country, we encourage the Finance Committee to support repeal of the estate tax now.

PREPARED STATEMENT OF JANET LOVELL AND THOMAS LOVELL

Thank you for the opportunity to speak today.

My name is Jan Lovell. I'm an owner, assistant manager and vice president of the Clear Lake Independent Telephone Company, a local exchange carrier for Clear Lake and nearby Ventura, Iowa with a combined population of about 9,000 people in the heart of the Midwest. I'm here to speak to you today about the devastating impact the current federal estate tax can have on small businesses, which are the nation's most bountiful provider of new jobs.

Just two years after Alexander Graham Bell patented the telephone in 1876, my maternal great-grandfather Charles Woodford and some other community-minded entrepreneurs saw how important this invention would be to the new settlement of Clear Lake, Iowa. They saw how it could help the young businessman who was just hanging out his shingle on Main Street and how it could provide important connections for the townspeople, including many immigrants who left their loved ones behind to begin new lives in the fertile lands of the prairie.

The first phones were connected in 1878 and the company was incorporated in 1895. The company's original nineteenth century mission was to provide dial tone and a connection to the outside world. But as but as customers have desired new services and as technology has advanced, our twenty-first century mission has grown into offering a multitude of advanced telecommunications services ranging from wireless to high speed Internet to video conferencing. The importance of telecommunications has grown beyond any nineteenth century entrepreneurs' dreams. Today, it fuels economic development, it is a basic necessity for any industry and it is a lifeline for a rural community.

But this lifeline is in danger of being cut because of the federal estate tax.

Our company is just one example of a small, capital-intensive business that spends a lot of time, money and resources trying to plan how to pay the federal tax bill when a family member dies. My mother, two sisters and I are the majority owners of the company and my father and husband own stock in it as well. Instead of focusing our limited resources on meeting important telecommunications needs, we find ourselves spending time with insurance representatives and lawyers to help us find a way through the maze of complex estate planning rules and regulations to do everything we can to keep the company in business when an owner dies.

The next speaker will give you details on what happened to us the last time a major stockholder, my grandmother Esther Woodford Ashland, died. It's a story of how, in spite of all of our family's planning through the years, we still don't know if this company will survive the next estate tax bill when my parents pass on.

There are those who might ask " . . . what does it matter if this little telephone company in northern Iowa has to close its doors because of federal estate taxes ?" To that question, I would submit to you that it does matter because even a small company like ours—with less than 30 employees—can have a strong, positive impact on a community's economy, an effect which ripples far beyond just the jobs for which we are responsible.

Our twenty-first century mission in this capital-intensive small business requires millions of dollars to deploy new broadband technologies and careful, strategic planning to determine which costly technology to deploy and when for our customers. Our earnings must be plowed back into the company network. We recently borrowed $9 million to rebuild our urban infrastructure and lay the groundwork for futuristic broadband services. This is the largest single capital project we've ever done in the company and a historic debt load for the company. We are willing to take on this risk because we feel that our customers must have access to the same quality of communications as someone living in a large city.

This kind of planning and risk taking, combined with local ownership, has some very clear benefits for our community in terms of new jobs, service to the customer and having some control over our community's future. In a state with a dwindling population, Clear Lake experiences moderate but steady growth.

One example of this occurred last year when a North Iowa high-tech software supplier and service provider needed to expand. Because of our local ownership and management and the advanced infrastructure we had in place, we were able to respond immediately to their intensive data needs. So instead of Kingland Systems Corporation moving to another part of the country, we were able to help them relocate here and expand in Clear Lake, providing 85 computer engineering and software developer jobs.

In contrast, we are surrounded by larger communities which are served by regional operating companies and others which are the result of mega-mergers. They haven't deployed high speed Internet access like DSL such as we have done. There is a waiting list to have basic phone service installed. There is no actual person to talk with face-to-face to answer questions. Offices have been closed and jobs lost in the name of corporate efficiency. Our rural areas are particularly hard hit because distant corporate managers can't cost-justify deploying advanced services to sparsely populated areas. And so the rural areas become disadvantaged simply because of where people live.

In Clear Lake, we install telephones within 24 hours or the same day whenever possible. The old-fashioned creed of "the customer is always right" is followed with the same zeal as when my grandfather was managing the company. Our customers are our neighbors. When we see them at church, at the school musical or at the local basketball game, they know they can talk with us and that we'll get the work done for them. We are willing to provide service that larger companies would never be able to cost-justify, such as dispatching an installer to make a home visit to help an elderly widow install her new Caller ID box, because we know it matters.

A second example of how a small, 26 employee company can have a much larger positive economic impact on its community is with the TeamQuest Corporation. When the Unisys Corporation closed its manufacturing facility in Clear Lake along with approximately 1,100 jobs, some of the local employees who liked Clear Lake's quality of life decided to spin off their own software development company. The TeamQuest Corporation has been able to expand to global markets and retain its headquarters in Clear Lake in part because of the telecommunications facilities we provide.

In contrast, we also know the harsh reality of a family business having to sell out to larger corporations. The Clear Lake Bakery, which was started by a German immigrant in the 1950s, grew to regional importance and employed over 300 people. But upon the passing of the founder, it was sold to a larger company which had numerous bakeries, was resold and ultimately was sold to a large regional baking company which decided to shut down the operation. Its empty storefront and warehouses in downtown Clear Lake are poignant reminders of what can happen.

We provide stable jobs to 26 professionals and their families. Most of these are long-term employees who share the vision of providing service to our community. We're proud of the fact that these hard-working employees have been able to make better lives for their children—like seeing them graduate from college. We relish the fact that we're a family-oriented business, that we have a chance to wish them happy birthday and attend their children's weddings and graduations and share life's important benchmarks with them.

In contrast, of all the companies which provide overlay competing services to our customers such as wireless companies, directory companies, business telephone system companies—none has an office in Clear Lake. To our knowledge not one employs a single Clear Lake resident. All of the revenues generated from their customers here leave this small community and go to corporate headquarters elsewhere.

We feel it's important to give back to the community. We donate generously not only of our financial resources, but our time. My husband Tom and I are co-chairing a capital campaign to raise $1.5 million for a library building expansion. It's a lot of money for a community our size, but we're driven to reach the goal because we believe in the library's important mission in a democracy such as ours. We know people who have encountered personal tragedies and have needed the services of the United Way and so we're a major contributor to this worthy organization, both financially and with volunteers.

Our schools need high speed Internet access to ensure that students will be well-equipped participants in the workforce and society so we provided free, high speed Internet access for the schools and a state of the art local area network; we are a major contributor to the local economic development corporation and to Opportunity Village, a residential facility for physically and mentally disabled; we've helped lead the way on improving our environment through recycling, Earth Day and lake water quality efforts. And our community provides public entertainment almost every weekend in the park, in part because of our regular sponsorship. We've been recognized as the corporate philanthropic organization of the year by a regional group, industry of the year by the local Chamber and other awards.

All of these factors are part of quality of life, a key reason to keep small companies such as ours in business instead of killing them with the death tax. That quality of life was important enough to me that 14 years ago I decided to leave my journalism career and make sure that a family member from my generation got involved in the business. I received hands-on experience working in all departments and commuted to Minneapolis for four years to obtain my master's degree in telecommunications. It's important to me to be part of an organization which has a positive ripple effect on our community—on our economy, our families and our daily lives. We're working hard to balance the demands of a fast-moving, high-tech society with old-fashioned service and basic family-centered values.

It's a commitment we've made in spite of the difficulties we encounter of trying to focus on what's best for our customers and our employees while also trying to ensure it won't all be taken away when the next estate tax bill comes due.

We first learned about this harsh possibility of losing everything while we were still mourning the passing of my grandmother Esther Woodford Ashland.

My name is Tom Lovell and I am the general manager and a vice president of the company.

It was shortly after December 4, 1984, when Jan's grandmother Esther Ashland died, that we discovered firsthand the potential crippling effect of the Federal Estate tax.

As was mentioned, our family was working with planners so we thought were prepared for the eventuality of the death tax. We soon saw the difficulty of the "fair market value" portion of the death tax as it applies to closely-held corporations. We filed a federal estate tax return showing a taxable estate of $3,866,977, with a federal estate tax owing of $1,404,772 and Iowa inheritance tax of $266,565. The return was examined and the IRS increased valuations by about $1 million on our family farm and woodland and telephone company increasing the total taxable estate to $4,988,717. This increased the federal estate tax burden to $1,897,928 and Iowa Inheritance tax to $390,366. Earl and Esther Ashland had done planning and purchased insurance, but it wasn't enough to cover the increased valuation.

In order to pay these death taxes and preserve the family farm and family owned telephone company, all of Esther's liquid assets and real estate except for her homestead were sold. The telephone company used all of its available liquid assets to redeem as much stock as possible. This left the telephone company with a minimal cash position with which to operate. The high estate values occurred because the farm and telephone company had to be valued at "fair market value" even though we had no intention of selling them. The century farm has a woodlands which had been a source of joy for many people for generations. But it includes a mile of undeveloped lakeshore and it was taxed at its "highest and best use or development potential" even though we never intended to develop it.

The valuation of a small, closely-held company is not easy to determine. We used experts who did an analysis of fair market value and yet the IRS did not accept this valuation. The majority of the investment in our company is in electronic switching and fiber and copper cables which have no other value except for use as a telephone company. We can't sell these assets off piecemeal. We are not a publicly traded company and therefore, it's difficult to get a per share value and find a comparable situation from a market value perspective.

Since the time of Esther Ashland's death, the family has spent an enormous amount of time, energy and money to prepare for the next imposition of estate tax when Jan's parents pass away. Fortunately, the state of Iowa has eliminated the inheritance tax on children and grandchildren, but the federal estate tax remains an imposing burden.

We have been able to implement some additional planning tools. After much research, we were able to place a conservation easement on the family woodland so it can never be developed and thus is not subject to a valuation that may force us to sell it or develop it. Because of this work, Lone Tree Woods will remain open for the public enjoyment as a natural area forever. In Iowa, public recreational lands are a rare commodity because our former prairies and wetlands are so highly productive for agriculture.

We have employed professional estate planners and attorneys from Minneapolis to help mitigate the financial impact that the next round of estate taxes will have on our company. The company has spent over $3,000,000 in insurance premiums over the past eight years to fund a stock redemption program that will generate the cash to pay the projected federal tax burden. Not included in this figure is the money spent for professional assistance and the time spent on estate planning instead of running the company.

Unfortunately, we may not be able to accomplish our goal. The telephone company must keep operating and investing in its operations to remain viable in today's competitive environment. We have always prided ourselves on being able to provide the best technology at an affordable cost to our customers. But the costs of providing these services continues to escalate. For example, in 1955, we paid approximately $225,000 for our Automatic Electric step switch. In 1995, it cost $1.5 million to purchase our second generation digital switch, an AT&T (now Lucent Technologies) digital switch. The useful life of a digital switch is now only seven years and replacement costs continue to escalate.

But we may have to choose between investing in our company to provide new services to our customers or setting aside funds to pay off the projected estate taxes. We can't do both. Our final choice may be to sell the company, which would be a loss to our employees and our community.

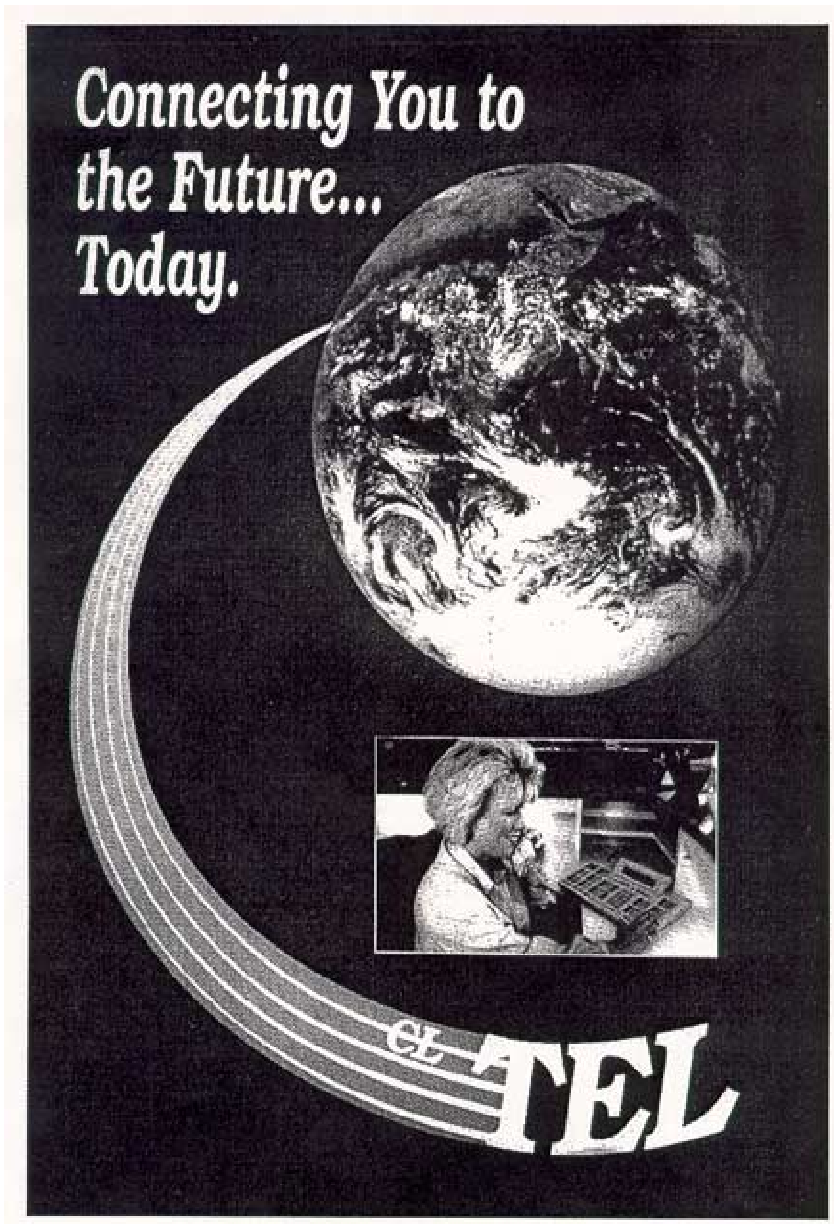
Some have said that with a little planning, no one pays any estate taxes. That is not true. Jan's grandparents, Earl and Esther Ashland planned and purchased insurance, her parents Marcia and Jim Connell have spent enormous financial and time resources and our families and Jan's sisters' families have as well. We have done an extraordinary amount of planning and we know there will be an enormous tax burden to pay. We have used and will continue to use revocable trusts, GRATS, charitable trusts and split dollar life insurance in hopes that we can keep our company intact. But the future is uncertain because of the company's ever-increasing "fair market" valuation that means so little to us but means everything to the IRS.

We are asking you to consider the severe impact the federal estate tax has on small family owned businesses such as ours. In the broader context, our situation is similar to that of family and locally owned businesses across the country. It's important to remember that small businesses are responsible for generating economic activity across the country. Small businesses create two-thirds of the new jobs in the United States, according to the National Federation of Independent Business. And 98% of the new businesses created in America are created by small business. Plus, 40 percent of the Gross Domestic Product is supplied by small business.

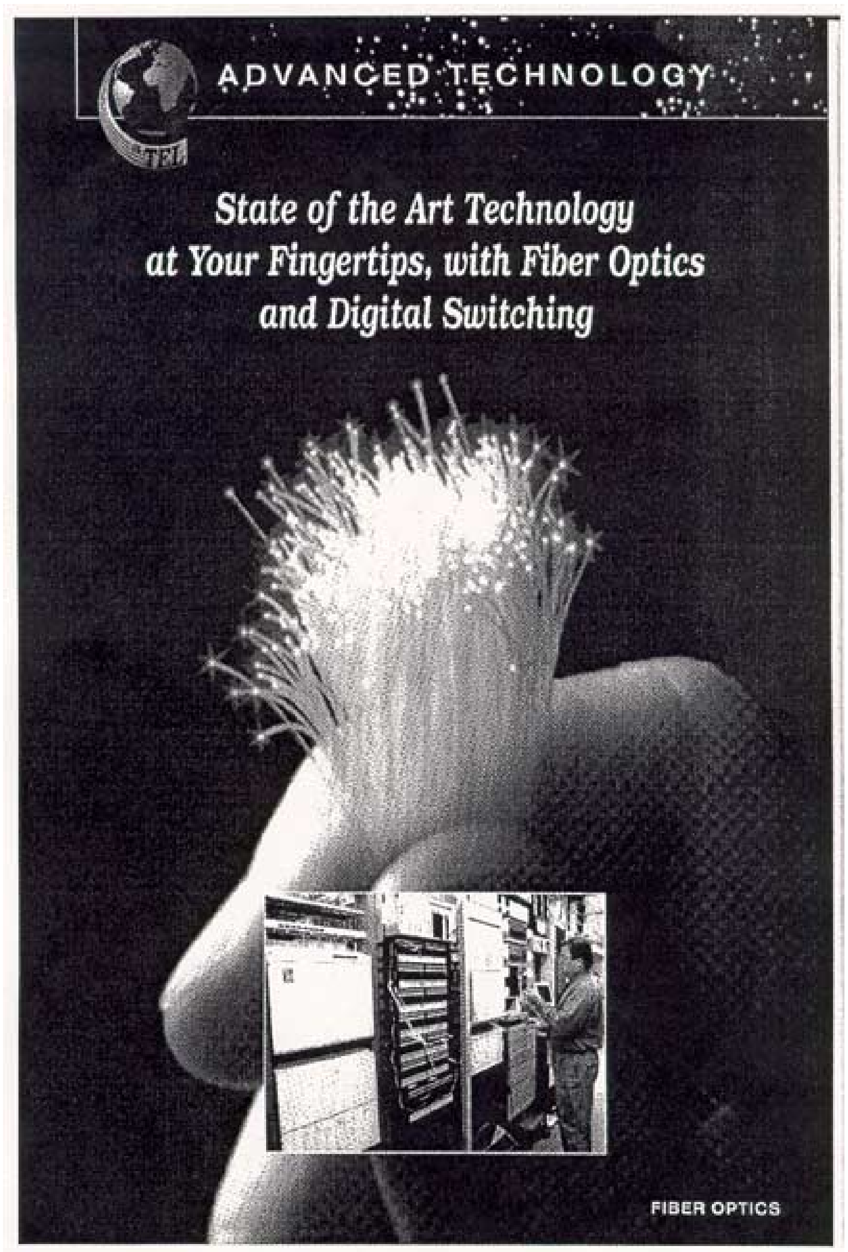
And our telephone company is just like hundreds of family owned telephone companies across the United States who are also on the front line managing their businesses day to day, trying their level best to provide advanced telecommunications for their communities. Countless hours and hundreds of thousands of dollars are spent annually to deal with death taxes when that time and money could be better spent operating our business.

We ask you to consider the impact on our employees and community if we are forced to sell our company to pay this exorbitant federal estate tax burden. We ask you to consider eliminating the death tax because it has consequences which were never intended— which is the forced sale of small, family owned businesses.

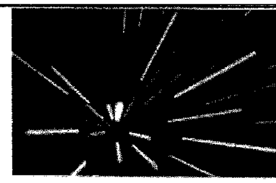
Thank you for your consideration.


Connecting You to
the Future...
Today.
TEL


YOUR BUSINESS DESERVES TO BE ON THE CUTTING EDGE
Quality and Reliability.
You need quality communications which are reliable and save you money. And you want a professional to cut through the complexities of the ever-changing telecommunications world so you can concentrate on your most important job – your business.
The CL TEL fiber optic and digital switching network handles your calls with state-of-the art quality and digital reliability.
One Stop Service.
At CL TEL, we know your time is valuable. As your one-stop, full-service communications center, you place one phone call for all equipment and service needs including:
business telephone systems, long distance services, ISDN, Centrex, pagers, consulting services, voice mail, cellular service, videoconferencing, fax service, 800 service . . .
FIBER OPTICS
The Ideal Blend of People and Technology.
Your CL TEL equipment and services are backed by a company which has provided over a century of quality service to businesses just like yours. We're here to help you save money, make sure your equipment works as hard as you do and to personally answer your questions.
The Bottom Line:
It's the best of both worlds for your business – CL TEL is locally owned and globally connected. In a world of faceless corporations, your business receives the personal attention it deserves. And you have access to competitive long distance rates and state-of-the-art technology. We're at your service.
The world at your fingertips
CL TEL
Clear Lake Independent Telephone Co.


ADVANCED TECHNOLOGY
State of the Art Technology
at Your Fingertips, with Fiber Optics
and Digital Switching
FIBER OPTICS

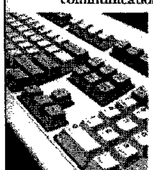
ADVANCED
TECHNOLOGY



State of the Art Technology is at the Heart of the CL TEL Telephone System.

Fiber Optic Transmission

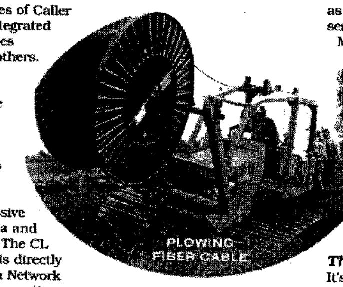
Fiber optic cables transmit communications at lightning speed around the lake and to the long distance network worldwide, while digital switching gives customers the advanced services of Caller ID, Integrated Services Digital Network and others. Each ensures that customers have the latest information age services at their fingertips.



The hair-thin strands of glass used in fiber optic cable have the capacity to carry massive amounts of voice, data and video at high speeds. The CL TEL fiber optic cable is directly connected to the Iowa Network Services statewide fiber optic network and from there, to the world. There also is a sophisticated fiber cable ring around the lake which re-routes itself if a main distribution link is cut around the lake.

Advanced Digital Switching

A new AT&T digital switch, installed at CL TEL in June, 1995, is a smaller company version of AT&T's most modern switching equipment used in metropolitan areas by Bell telephone companies. The switch processes and controls all telephone calls for customers. It provides advanced services such as caller identification, *ISDN*, *Centrex* and others and serves as a platform for an ever-evolving array of new services. *ISDN* provides high-speed communication links which can combine voice, data and graphics on the same line.



Centrex enables a business owner to enjoy the advanced features of a sophisticated telephone system, but without the investment of having equipment on site. High speed data circuits, voice mail, paging and cellular round out services provided by CL TEL.

The Right Connections

CL TEL is part of a statewide consortium of independent telephone companies which formed Iowa Network Services to ensure access to the latest in telecommunications services and technologies such as competitive long distance services and videoconferencing.

Many of the approximately 1,500 independent telephone companies from across the country are providing advanced telecommunications services for their communities as they leverage their local commitment and responsiveness with a network of industry partnerships.

The Best of Both Worlds

It's the best of both worlds for your business - CL TEL is locally owned and globally connected. You have access to the latest services and technologies, and yet your business receives the personal attention it deserves. We're at your service.

We make it easy for you CL TEL

Clear Lake Independent Telephone Co.

107 North 4th Street • Clear Lake, Iowa 50428
Phone 515-357-2111 or 1-800-642-6201 • FAX 515-357-8800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DSL isn't a pipe dream and it isn't hype. Simply put, DSL is the fastest, easiest way to get incredibly high transfer speeds - up to 25 times faster than dial up access. And DSL is always on. With just a click- you are logged on and flying around the Internet. CL Tel DSL is right here, right now, and ready to amaze you.
Order CL Tel DSL right now and you'll get our special "ClearSpeed" introductory package including free installation and your first two months of DSL access absolutely free. You'll get everything you need including professional installation from the folks that you trust for reliable service- Clear Lake Telephone. Sign up today and get everything you need to blaze across the Internet!
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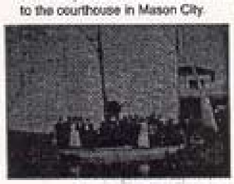
CL-TEL

A Century of Service

Within just two years after Alexander Graham Bell uttered his first words over the telephone in 1876, Clear Lake residents were using the incredible invention.

"The telephone wave has struck this place and lines are running all over town," reported the May 29, 1878 Clear Lake Observer newspaper. Within a year, Clear Lake pioneer George Frost made Iowa's first long distance phone call from Clear Lake to the courthouse in Mason City.



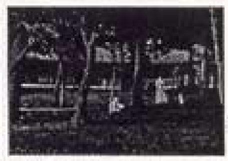
The fervor with which Clear Lake residents embraced this technology was characteristic of this special area. Clear Lake's pioneering role in Iowa telephone history paralleled its special roles in other facets of Iowa regional history. The spring-fed waters have long attracted diverse groups and new ideas. A favorite campsite for the Sioux and Winnebago Indians, Clear Lake later cradled the intellectual and often spiritual spark of the Chatauqua, the gaiety of the dance halls, the bold social experiment of the Outing Club and the unflagging attitude that helped create "Corn Money" to provide hope in the depths of the Great Depression.

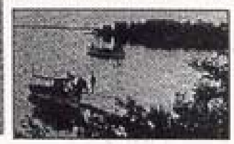
It was the same pioneering and community-minded spirit which motivated a group of 24 Clear Lake men to ensure in 1895 that everyone who wanted telephone service could have it.

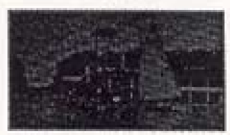
CL TEL

[illegible]

Just prior to the turn of the century, organizers decided to incorporate. D.H. Palmeter was elected president and the following men were elected directors: J.L. Etzel, D.H. Palmeter, B.A. Brown, C.E. Elce, L.F. Bass, and C.R. Woodford. The office was moved to the back of the bank building at the corner of Main and 4th Street and soon Percy Flatter began what was to become his life-time career as manager of the telephone company.



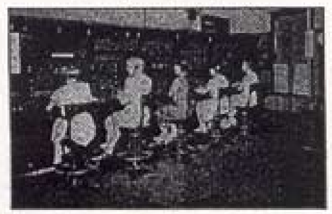


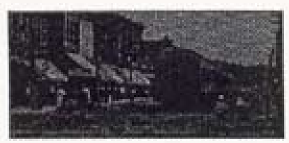


Organizers of the company include many of Clear Lake's pioneering families: D.H. Palmeter, L.F. Bass, J.B. Patterson, John Ott, F.E. Bolton, Charles H. Elce, G.A. Watts, J.C. Wright, J.H. Woodstock, John L. Etzel, C.R. Woodford, C.M. Lambertson, D.H. Culver, John Halverson, E.I. McGraw, D.B. Herreman, F.L. Jones, P. Knutson, R.S. Young, I.E. Stewart, F. McDonald, G.F. McDowell, B.A. Brown, and M.J. Hare.

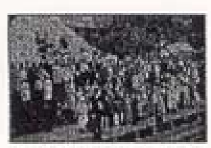
Within a year, the office was moved to 318 Main Avenue, the jewelry store of J.B. Patterson. He, his wife, and son ran the switchboard and conducted the business. Soon, they hired Nellie Johnson (Epperson) as operator.

Businesses could have their own service for $1.50 per month by 1909. At this time, there were over 700 telephone exchanges in Iowa. Clear Lake bustled with activity as the electric interurban carried passengers from Mason City and the train stations down Main Street to the lake. Visitors traveled from throughout the Midwest to gather in the octagonal-shaped Chatauqua building in the campgrounds area to hear nationally-known leaders such as presidential candidate and orator William Jennings Bryan, Booker T. Washington, Billy Sunday, and prohibitionist Carrie Nation.



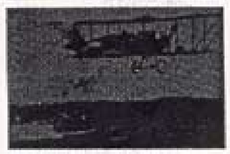


When the central office was moved in 1912 to the second floor of a building at 310 Main Street, the telephone was already being used to save lives. When an operator received an emergency call, she would flick on a red light suspended from a wire across main street to signal a policeman.

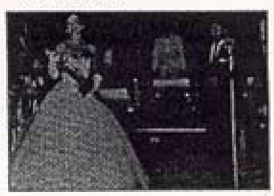


After the war to end all wars was over and many of Clear Lake's sons returned home, the Clear Lake Telephone Company and Clear Lake residents again focused their efforts on building their community. The common battery telephone system was installed in 1928.

The community spirit prevailed even in the depths of the Depression when business leaders devised a plan in 1933 to buy corn from the farmers and in return, issue scrip or "corn money" to pay the light bill or purchase other services. L.E. Ashland, who later served as telephone company president, was one of the businessmen who created the idea which received national attention.



With the attack on Pearl Harbor in 1941, war in distant countries again touched Clear Lake families. And at the conclusion of World War II, residents again focused their energy on building homes, businesses, and prosperity in the community. Rural telephone lines were purchased and consolidated with the city of Clear Lake in the 1950s in preparation for conversion to a new dial switching system. A new telephone business and central office facility was constructed at 107 North 4th Street in 1954. A new dial switch was cut over in 1955, giving Clear Lake residents one of the most "modern, up to date plants in the state" according to the local newspaper.



While Clear Lake residents were enjoying their advanced telephone equipment, the city was in the state and national spotlights as the host community for the Miss Iowa Pageant for many years and on February 2, 1959 when the Surf Ballroom was the scene of famed rock and roll star Buddy Holly's final concert. The Ventura Telephone Company was purchased from A.E. (Ed) Nelson in 1960 and operated as a separate unit since that time.

CL-TEL

The information age was ushered into Clear Lake with the installation of a $1 million digital telephone switch in 1982. The digital switch improved voice and data transmission and provided new electronic feature capabilities. The [illegible] the breakup of the Bell System in 1984 and [illegible] soon on [illegible] a host of new telecommunications [illegible].

Continuity and a solid foundation for the company's future have been provided by four generations of the family of C.R. and Agnes Woodford and the company's three longtime managers. Four family members have served as president including: Charles R. Woodford (serving as president from 1913-37 and vice president from 1937-1947); Ronald Wood Woodford (1937-1947); Esther Woodford Ashland (1947-1952); [illegible] Ashland (1953-1980 as general manager and president); and Marcia Ashland Connell, who has served as president since 1989. Fourth generation family members are active in the daily management of the company today. The three dedicated managers who have served the company in its history include Percy Fisher; Harold Thompson, who was with the company from 1944-1988 including serving as president from 1980-1988; and Robert S. Halford, who began employment at the telephone company in 1954 and currently serves as general manager.

This same pioneering vision of the company's founders is the inspiration for the company's mission today - to provide Clear Lake and Ventura residents with access to the latest telecommunications technologies at a reasonable cost and with superior service by our longtime and dedicated employees. As one of Iowa's largest independent telephone companies, CL-TEL remains locally owned and operated [illegible].

[illegible]

CL TEL

And to mark our century of service in 1995, CL TEL:

- installed a new state-of-the-art AT&T digital switch to enhance voice and data transmission and provide sophisticated new services such as ISDN, Centrex, and caller identification.
- opened a futuristic videoconference facility to provide customers with a world-wide video link.

These technologies make our life fuller, easier, and safer for our families, friends, and businesses. With a local telephone network that exceeds the quality of most sophisticated urban networks, ours is an opportunity to make Clear Lake an oasis in a parched world. We have instant access to a world full of information and knowledge, yet can live in a community with hard-working, well-educated, and caring people, safe and uncrowded streets, a variety of recreational opportunities, fresh air, and natural beauty.

100 1895 CL TEL 1995 CONNECTING YOU TO THE FUTURE

1995 is a watershed year for our telephone company and our community, as we reinvest in our people, Main Street, local industry, and our telecommunications infrastructure. It's a time when we can look back with pride on our past and work toward a vibrant future, in this special place we call home.

6

PREPARED STATEMENT OF HON. DON NICKLES

This is a hearing of the Senate Finance Subcommittee on Taxation and IRS Oversight on the death tax. Since this is the first meeting of the subcommittee in the 107th Congress, I would like to welcome my ranking member, Senator Conrad, and the other members of the subcommittee and the full committee who have joined us this morning.

Today we will hear testimony from two panels of witnesses. The first panel will include taxpayers who have suffered the effects of the death tax. The second panel of economists and professionals will speak to the economic impact of the death tax and the challenges we face in legislating its repeal.

My hope is that after I make a brief statement, and provide the same opportunity to Senator Conrad, that we can proceed to the first panel of witnesses and then to a round of questions.

The death tax is confiscatory, anti-family, and anti-growth. Most Americans work diligently throughout their lives to provide for their families and give their children and grandchildren a better future. This work often results in the accumulation of assets like homes, businesses, and farms; all acquired with hard work and bought with after-tax dollars. Unfortunately, those without high-paid lawyers and accountants realize too late that up to 60 percent of those assets could be confiscated by the federal government upon their death.

Death should not be a taxable event. The Death Tax Elimination Act that passed Congress overwhelmingly last year, and was vetoed, would shift the incidence of tax to the eventual sale of inherited assets by the heirs, at which time a capital gains tax is collected. This not only makes economic sense, but it also address the political concerns of those who fear that the "super rich" will somehow escape taxes altogether.

Some of my colleagues, and some of our witnesses, will suggest that we don't need to repeal the death tax, but rather just reform it by increasing the exemption or reducing the tax rates. They point to the fact that only 2% of estates pay the tax.

While the death tax most certainly affects those who actually pay it, it also affects many others who must engage in costly estate-planning to prepare for the tax, whether or not they will ultimately have to pay it. When a family-owned business or farm is sold to pay the death tax, its employees are hit with a 100% death tax—the loss of their jobs.

It all essentially comes down to this. Is it fair for the Government to confiscate up to 60% of someone's property or business for which they worked their entire life?

Absolutely not. Fortunately, the American people and a majority in Congress understand that the Death Tax is simply unfair. That's why we will successfully repeal it this year.

PREPARED STATEMENT OF GARY ROBBINS

Mr. Chairman and members of the Committee, I am Gary Robbins, President of Fiscal Associates and Senior Research Fellow at the Institute for Policy Innovation (IPI). I thank you for the invitation to appear at this hearing on "Preserving and Protecting Family Business Legacies." My remarks summarize work on estate taxes that Aldona Robbins and have been doing for IPI.[1]

Until recently estate taxes were the almost exclusive headache of the super rich, their tax attorneys and their estate planners. But, a strong economy, an ever-widening distribution of wealth—both good things—coupled with tax policy that has failed to keep up with economic growth have extended the reach of estate taxes well into middle class America.

I would like to begin with a brief history of estate taxes, discuss the economic implications of estate taxes, look at some examples of how the estate tax affects family businesses, and conclude with some suggestions as to how the tax should be changed.

A BRIEF HISTORY OF THE ESTATE TAX

Estate taxes date back almost three thousand years. As early as 700 B.C., there appears to have been a 10 percent tax on the transfer of property at death in Egypt.[2] In the first century A.D., Augustus Caesar imposed a tax on successions and legacies to all but close relatives.

Transfer taxes during the Middle Ages grew out of the fact that the sovereign or the state owned all assets. Although the king owned all real property in feudal England, he did grant its use to certain individuals during their lifetimes. When they died, the king would let the estate retain the property upon payment of an estate tax.

In the United States, the tradition of taxing assets at death began with the Stamp Act of 1797. While the first Stamp Act on tea helped precipitate the Revolutionary War, the second was far less dramatic. Revenues from requiring a federal stamp on wills in probate were used to pay off debts incurred during the 1794, undeclared naval war with France. Congress repealed the Stamp Act in 1802.

That set a pattern for the next hundred years or so in which estate taxes were used as a sporadic, and temporary, way to finance wars. When hostilities ceased, the tax was repealed.

In 1874, a taxpayer challenged the legality of the Civil War estate taxes, arguing they were direct taxes which, under the Constitution, must be apportioned among the states according to the census. The Supreme Court disagreed saying that direct taxes pertained to capitation taxes and taxes on land, houses and other permanent real estate.[3]

Another legal decision bearing on, but not directly related to, estate taxes concerned The Income Tax Act of 1894, which included gift and inheritances as income subject to tax. The Supreme Court struck down the whole bill because the tax was imposed on, among other things, real estate gains and, therefore, considered a direct tax.[4] This decision is particularly notable because it set the stage for the Sixteenth Amendment which allows the federal government great latitude in the types of taxes it can collect.

The Modern Estate Tax Evolves: 1916 to 1975

In the early 20th century, worldwide conflict cut into trade tariffs—a mainstay of federal revenues—and Congress turned to another revenue source. The Revenue Act of 1916, which introduced the modern day income tax, also contained an estate tax with many features of today's system. After an exemption of $50,000 (almost $11 million in terms of today's wealth), tax rates started at 1% and climbed to 10% on estates over $5 million (over $1 billion in terms of today's wealth). Estate taxes were increased in 1917 as the U.S. entered World War I.

However, unlike before, the estate tax did not go away after the war ended. Despite sizable budget surpluses, Congress increased rates and introduced a gift tax in 1924. Like the estate tax, the gift tax is a levy on the transfer of property from one person to another. During the 1920s through the 1940s, estate taxes were used as another way to attempt to redistribute income. Tax rates of up to 77 percent on the largest estates were supposed to prevent wealth becoming increasingly concentrated in the hands of a few.

While the Internal Revenue Code of 1954 overhaulded the federal income tax, it made a seemingly minor structural change to estate taxation. Specifically, it expanded the tax base to include most life insurance proceeds, which could substantially raise an estate's tax bill.

Reshaping Federal Transfer Taxes: 1976 to the Present

During the late 1960s and early 1970s loophole closing preoccupied tax reformers. These efforts culminated in a 1976 tax bill which overhauled estate taxation, giving us the system we still have today. Perhaps the biggest change was combining the previously-separate exemptions for estate and gift taxes and transforming them into a single, unified estate and gift tax credit.

The 1981 tax bill brought some relief. Rates were cut—the top rate went from 70 to 50 percent, and an increase in the unified credit took a lot of smaller estates—those under $600,000—off the tax rolls. But, after that, the search for revenue to close budget deficits led to more than a decade of bills that largely increased estate taxes.

In 1997, Congress provided some relief with the first increase in the unified credit since 1987. Gradual increases, which began in 1999, are slated to raise the unified credit to $1 million by 2006.

Summary of U.S. Estate Taxation

Several main points emerge from the history of estate taxation in the United States:

- Until the 1920s, estate taxes were used as a sporadic, and temporary, way to finance wars. When hostilities ceased, the tax was repealed.
- From the 1920s through the 1940s, estate taxes became another weapon in the arsenal to redistribute income. Tax rates of up to 77 percent of the largest estates were supposed to prevent wealth becoming increasingly concentrated in the hands of a few. Graph 1 shows the starting and top estate tax rates since 1916.
- Loophole closing preoccupied tax reformers during the late 1960s and early 1970s. Their efforts culminated in a 1976 tax bill that overhaulded estate taxation and combined the estate and gift tax exemptions into a unified credit.
- Lower income tax rates enacted in 1981 were extended to estate taxes and the exemption was increased to remove smaller estates from the tax rolls.
- Since then, estate taxes have been on the rise, this time a weapon in the arsenal to reduce federal deficits. Time has seriously eroded the value of the estate tax exemption.

ESTATE TAXES AND THE ECONOMY

The estate tax has a large dead-weight loss. Because the estate tax falls on assets, it reduces incentives to save and invest and, therefore, hampers growth. Along with income taxes, estate taxes help raise the tax rate on income from assets relative to income from working. This unequal treatment of income leads to an inefficient mix of capital and labor.

The size of the dead-weight loss depends on how much of a nation's assets are subject to the tax and the amount of distortion. The estate tax exemption determines the proportion of wealth covered and the rate structure determines the degree of the distortion.

A rough measure of the distortion is the ratio of marginal to average rates for those paying the tax. The average rate is a proxy for the amount of revenue raised while the marginal rate is a proxy for the overall price distortion. Under a uniform tax, the ratio would be one and the amount of distortion would be minimized. The greater the difference between the marginal and average tax rates, however, the greater the distortion and, therefore, the larger the dead-weight loss.

Currently, the marginal estate tax rate is nearly 3 times higher than the average. Even though the estate tax rate structure is progressive, the high ratio is due mostly to the unified credit. In 1916, the statutory exemption was $50,000. Adjusting the exemption for the growth in wealth between 1916 and 2001 indicates that estates under $11 million (in today's wealth) would not have been taxes. In 1931, the exemption was worth even more—$13.6 million (in today's wealth). As Graph 2 shows, however, since then the real value of the exemption has fallen dramatically. The low of about $343,000 was reached in 1976.

Tax bills in 1981 and 1997 provided modest increases in the exemption. However, the exemption of $675,000 in 2001 is still a far cry from its $11 million counterpart in 1916. This failure of the estate tax exemption to keep up with rising wealth is the main reason increasing numbers of average Americans face the prospect of having their heirs presented with an estate tax bill. A middle class family who owns a home and has IRAs, 401(k)s or other retirement accounts could easily have assets exceeding $675,000 today or even $1 million five years from now.

While the eroding exemption has greatly expanded the estate tax base, both the lowest and highest tax rates also have gone up significantly since 1916. As a result, more of a taxable estate is taxed at the highest marginal rate. As Graph 3 shows, in 1916, only estates over $1 billion (in today's wealth) would have been taxed at the top rate of 10%. Contrast that with the top rate of 55% on estates of $3 million in place this year.

The applicable rates are more compressed than Graph 1 suggests because of the unified credit. Under an exemption system, the estate would begin paying tax at the lowest statutory rate. Under the credit, however, the effective bottom rate is not the statutory 18% shown in the graph, but 39%. While current effective tax rates range from 39% to 55%, as the credit continues to erode in value, the lowest effective rate will rise to 41% by 2006.

EFFECT ON FAMILY BUSINESS

The estate tax is particularly harmful to families who own businesses or farms. Even though the amount of the tax is based on asset value, the simple fact is that the tax must be paid out of income.

Let us look at two small business examples. Take a family-run store yielding a 10 percent return each year. Taxes reduce the return to 5 percent.[5] If the owner dies and is subject to the 55 percent estate tax rate, how do the heirs pay the bill? They could send 55 percent of the store's inventory or other physical assets to Washington except Treasury does not accept payment-in-kind, only cash. Devoting the entire 5% annual return, the heirs could be pay off the estate tax in only 11 years except Treasury wants the money now. The heirs could borrow from the bank at 9% (4.5% after tax) and pay off the loan in 50 years, but rather than run the store for 50 years for free, they probably would sell.

This example is not as outlandish as one might think. Consider the small farmer who owns land near an urban areas. His farm would yield a 10% return only when it is valued as farm land. But, tax law requires that the asset be valued as its "best use," lowering the pretax return to 5% (2.5% aftertax). In this case, even the 50-year bank loan will not save the farm.

The lesson to be learned here is that all taxes are paid out of income. Even if the estate tax is a "rare" event, only one chance in a lifetime, its average impact is very large—large enough that for some the combined effects of income and estate taxes approach 100 percent.[6] The prospect is that as much as 55% of the principal of any investment will be taken in estate taxes on top of income taxes. In cases like these, the clear message is "don't invest, consume."

The Congress has tried to address the hardship circumstances for farmers and small business in general. But, the remedy effectively has the government standing in for the bank. The final result is the same—heirs are left with a choice of owning a nonperforming asset for a number of years or simply selling. What is more, the

IRS has taken these half measures as an excuse to raise appraised estate value, thereby reducing the tax relief.

The investment decision becomes even more complicated if there are ways to organize holdings to pass the income stream to heirs. Tax planning can significantly mitigate the effect of the estate tax. Because amounts involved tend to be large, estate planning richly rewards taxpayers who can anticipate that they might be subject to the tax. Those that do not plan or cannot anticipate are caught and pay the tax. This is simply unfair.

That is one reason why the largest estates do not pay the highest tax rates. Who does? Typically they are owners of small businesses, family farms and savers who amass wealth during their lifetimes through hard work and thrift. Because wealth is often unexpected, these people may not be aware of, or take full advantage of, ways to reduce estate taxes. As a result, those who come late, or not at all, to estate planning end up paying most of the tax.

CONCLUSION

In summary, the estate tax is one of the most inefficient features of the current tax system. Its sheer complexity results in high compliance costs—as much as estate taxes raise by some estimates. High compliance costs along with distortions to economic activity warrant serious reduction or outright elimination of estate taxes.

Failing repeal, the exemption should be raised significantly. Increasing the exemption to the range of $5 to $10 million would restore eroded value and reduce the proportion of wealth subject to tax to be more in line with the 1920s and 1930s.

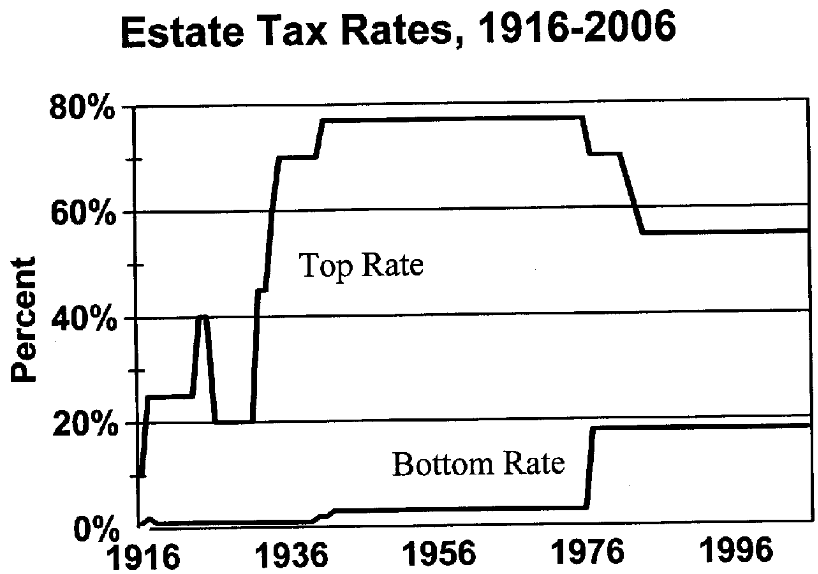
This would only partially address the impact of the tax, however. Under the unified credit structure, raising the exempt amount above $3 million would make the lowest marginal rate 55%, meaning the tax would be even less efficient than current law. While the amount of wealth subject to tax would be reduced, the rate structure would be harsher, increasing the ratio of marginal to average rates. The way to avoid this result is to convert the exemption from a credit to a deduction.

Another desirable change would be to expand the rate brackets. As we have seen the current rate brackets have become compressed when compared to prior law. Expanding the brackets would reduce marginal rate relative to the average and produce a more efficient system. Similarly, reducing estate tax rates would also help to improve the system The best solution, however, would be to eliminate the estate and gift tax altogether.

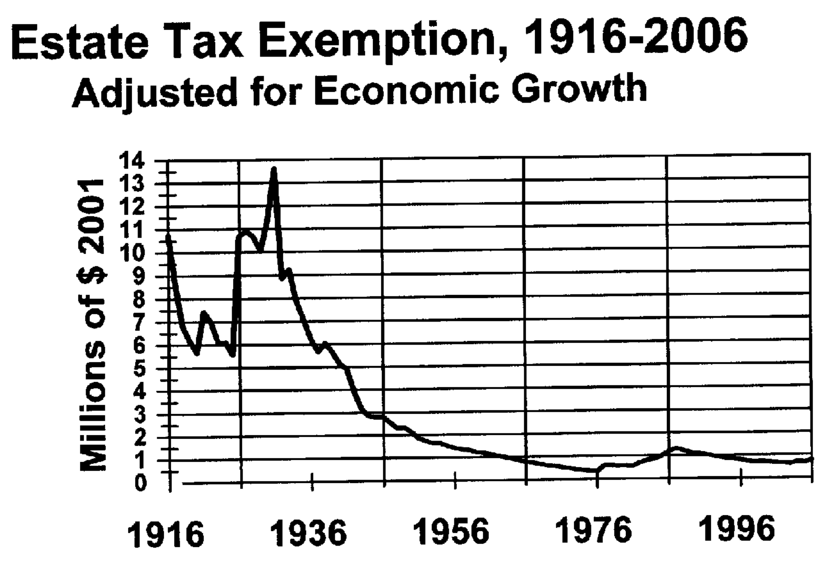
ENDNOTES

1. Gary and Aldona Robbins, *The Case for Burying the Estate Tax*, Lewisville, TX: Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 150, March 1999. This report is available at the website *www.ipi.org*.
2. More on the history of estate taxes is available in John R. Luckey, “A History of Federal Estate, Gift and Generation-skipping Taxes,” Congressional Research Service, March 16, 1995 and Martha Britton Eller, “Federal Taxation of Wealth Transfers, 1992–1995,” *SOI Bulletin*, Winter 1996–97.
3. *Scholey v. Rew*, 23 All. (90 U.S.) 331 (1874).
4. *Pollock v. Farmers' Loan and Trust Company*, 158 U.S. 429 (1895).
5. A tax rate of 50 percent might seem high, but we calculate the economy-wide, marginal tax rate on private business capital at roughly 67 percent.
6. The impact of a tax imposed on assets must be multiplied by one divided by the aftertax rate of return. Thus, the impact of the estate tax is magnified by 10 for an asset with an aftertax return of 10% and by 20 for an asset with a 5% return.

Graph 1



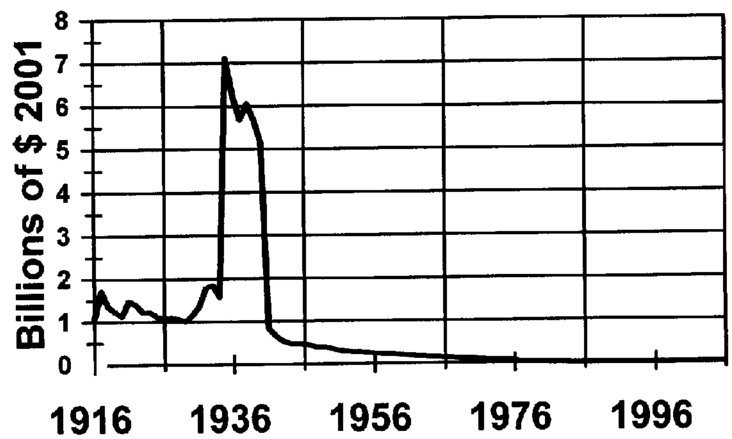
Graph 2



Graph 3

Estate Tax Top Bracket, 1916-2006

Adjusted for Economic Growth



Data Appendix

History of Estate Tax Filing Requirements and Tax Rates, 1916-2006

The tables below show the amount of estate exempt from tax, the lowest tax rate, top rate, and the amount above which the top rate apples. The column (1) contains the nominal statutory estate exempted from tax.

Column (2) adjusts the statutory amount by an inflation index to reflect that amount in 2001 dollars. Adjusting for inflation provides the level required to tax the same level of estate. We have used the GDP deflator from the Commerce Department's National Income and Product Accounts (NIPA) released February 2001 to construct the inflation index.

Column (3) adjusts the exempt amount for the change in the amount of economic wealth. Adjusting for wealth provides the level required to tax the same proportion of wealth across time. We have constructed the wealth index using nominal GDP from NIPA as a proxy for national wealth.

Columns (4) and (5) contain the bottom and top statutory tax rates applicable to estates.

The last three columns parallel the first three. Column (6) shows the statutory level at which the top rate begins to apply. Column (7) contains the top bracket adjusted for inflation. Column (8) shows the top bracket adjusted for wealth. The indexes used for the adjusted series are as described above.

History of Estate Tax Filing Requirements and Tax Rates, 1916-1961

	Exemption Amount			Initial	Top	Top Bracket Amt		
	Statutory	$ 2001	2001 Wealth	Rate	Rate	Statutory	$ 2001	2001 Wealth
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1916	50,000	609,423	10,735,605	1%	10%	5,000,000	60,942,288	1,073,560,483
1917	50,000	490,810	8,584,929	2%	25%	10,000,000	98,162,074	1,716,985,806
1918	50,000	436,167	6,787,038	1%	25%	10,000,000	87,233,493	1,357,407,626
1919	50,000	382,216	6,172,973	1%	25%	10,000,000	76,443,288	1,234,594,555
1920	50,000	335,462	5,666,991	1%	25%	10,000,000	67,092,427	1,133,398,280
1921	50,000	402,555	7,450,140	1%	25%	10,000,000	80,510,912	1,490,027,912
1922	50,000	437,909	6,997,702	1%	25%	10,000,000	87,581,731	1,399,540,387
1923	50,000	427,665	6,093,181	1%	25%	10,000,000	85,533,035	1,218,636,224
1924	50,000	428,500	6,121,956	1%	40%	10,000,000	85,700,092	1,224,391,295
1925	50,000	422,721	5,569,599	1%	40%	10,000,000	84,544,214	1,113,919,900
1926	100,000	858,678	10,691,334	1%	20%	10,000,000	85,867,803	1,069,133,429
1927	100,000	877,569	10,927,918	1%	20%	10,000,000	87,756,894	1,092,791,809
1928	100,000	863,749	10,691,334	1%	20%	10,000,000	86,374,896	1,069,133,429
1929	100,000	867,163	10,058,772	1%	20%	10,000,000	86,716,299	1,005,877,232
1930	100,000	900,244	11,424,914	1%	20%	10,000,000	90,024,398	1,142,491,446
1931	100,000	1,004,614	13,617,424	1%	20%	10,000,000	100,461,366	1,361,742,415
1932	50,000	568,989	8,869,853	1%	45%	10,000,000	113,797,878	1,773,970,561
1933	50,000	584,960	9,247,293	1%	45%	10,000,000	116,992,020	1,849,458,670
1934	50,000	553,732	7,902,233	1%	60%	10,000,000	110,746,381	1,580,446,500
1935	50,000	543,348	7,115,243	1%	70%	50,000,000	543,348,355	7,115,243,452
1936	50,000	537,381	6,231,151	1%	70%	50,000,000	537,381,201	6,231,151,075
1937	50,000	515,198	5,675,162	1%	70%	50,000,000	515,197,908	5,675,161,534
1938	50,000	530,722	6,057,460	1%	70%	50,000,000	530,722,257	6,057,460,453
1939	50,000	537,047	5,668,993	1%	70%	50,000,000	537,047,069	5,668,992,880
1940	50,000	529,418	5,148,542	2%	70%	50,000,000	529,418,058	5,148,542,399
1941	60,000	595,006	4,939,675	2%	77%	10,000,000	99,167,606	823,279,155
1942	60,000	551,587	3,868,089	3%	77%	10,000,000	91,931,090	644,681,514
1943	60,000	523,823	3,154,520	3%	77%	10,000,000	87,303,824	525,753,372
1944	60,000	511,988	2,848,688	3%	77%	10,000,000	85,331,251	474,781,379
1945	60,000	498,290	2,806,533	3%	77%	10,000,000	83,048,360	467,755,466
1946	60,000	444,421	2,815,370	3%	77%	10,000,000	74,070,165	469,228,381
1947	60,000	401,442	2,560,789	3%	77%	10,000,000	66,906,923	426,798,155
1948	60,000	379,715	2,321,427	3%	77%	10,000,000	63,285,866	386,904,559
1949	60,000	380,179	2,337,904	3%	77%	10,000,000	63,363,249	389,650,613
1950	60,000	376,076	2,126,595	3%	77%	10,000,000	62,679,259	354,432,446
1951	60,000	350,844	1,843,466	3%	77%	10,000,000	58,473,999	307,244,386
1952	60,000	345,369	1,745,278	3%	77%	10,000,000	57,561,575	290,879,724
1953	60,000	340,964	1,647,425	3%	77%	10,000,000	56,827,411	274,570,858
1954	60,000	337,583	1,642,238	3%	77%	10,000,000	56,263,911	273,706,295
1955	60,000	331,827	1,507,362	3%	77%	10,000,000	55,304,510	251,227,045
1956	60,000	320,787	1,428,897	3%	77%	10,000,000	53,464,420	238,149,473
1957	60,000	310,538	1,356,136	3%	77%	10,000,000	51,756,281	226,022,685
1958	60,000	303,331	1,337,587	3%	77%	10,000,000	50,555,142	222,931,116
1959	60,000	299,919	1,233,458	3%	77%	10,000,000	49,986,451	205,576,407
1960	60,000	295,725	1,186,683	3%	77%	10,000,000	49,287,440	197,780,563
1961	60,000	292,458	1,146,888	3%	77%	10,000,000	48,742,930	191,148,010

History of Estate Tax Filing Requirements and Tax Rates, 1962-2006

	Exemption Amount			Initial	Top	Top Bracket Amt		
	Statutory	$ 2001	2001 Wealth	Rate	Rate	Statutory	$ 2001	2001 Wealth
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1962	60,000	288,549	1,067,105	3%	77%	10,000,000	48,091,520	177,850,757
1963	60,000	285,358	1,011,568	3%	77%	10,000,000	47,559,661	168,594,584
1964	60,000	281,148	941,988	3%	77%	10,000,000	46,857,982	156,997,997
1965	60,000	275,987	869,125	3%	77%	10,000,000	45,997,771	144,854,144
1966	60,000	268,335	792,926	3%	77%	10,000,000	44,722,509	132,154,401
1967	60,000	260,280	750,338	3%	77%	10,000,000	43,379,923	125,056,311
1968	60,000	249,539	686,623	3%	77%	10,000,000	41,589,762	114,437,157
1969	60,000	237,861	635,194	3%	77%	10,000,000	39,643,503	105,865,695
1970	60,000	225,832	601,959	3%	77%	10,000,000	37,638,673	100,326,507
1971	60,000	215,003	554,543	3%	77%	10,000,000	35,833,864	92,423,772
1972	60,000	206,242	504,560	3%	77%	10,000,000	34,373,730	84,093,413
1973	60,000	195,300	451,719	3%	77%	10,000,000	32,549,997	75,286,517
1974	60,000	179,205	416,960	3%	77%	10,000,000	29,867,525	69,493,317
1975	60,000	163,912	382,740	3%	77%	10,000,000	27,318,661	63,790,037
1976	60,000	155,132	343,142	3%	77%	10,000,000	25,855,297	57,190,344
1977	120,000	291,499	616,183	18%	70%	5,000,000	12,145,808	25,674,281
1978	134,000	303,889	608,801	18%	70%	5,000,000	11,339,156	22,716,466
1979	147,000	307,725	597,471	18%	70%	5,000,000	10,466,823	20,322,138
1980	161,000	308,694	600,723	18%	70%	5,000,000	9,586,782	18,656,007
1981	175,000	306,906	582,958	18%	70%	5,000,000	8,768,747	16,655,937
1982	225,000	371,430	720,104	18%	65%	4,000,000	6,603,198	12,801,849
1983	275,000	436,686	811,483	18%	60%	3,500,000	5,557,826	10,327,962
1984	325,000	497,585	862,018	18%	55%	3,000,000	4,593,096	7,957,088
1985	400,000	593,672	990,358	18%	55%	3,000,000	4,452,538	7,427,686
1986	500,000	726,094	1,171,253	18%	55%	3,000,000	4,356,564	7,027,519
1987	600,000	845,905	1,319,677	18%	55%	3,000,000	4,229,525	6,598,385
1988	600,000	818,102	1,225,176	18%	55%	3,000,000	4,090,508	6,125,882
1989	600,000	788,054	1,140,181	18%	55%	3,000,000	3,940,272	5,700,906
1990	600,000	758,529	1,078,468	18%	55%	3,000,000	3,792,646	5,392,342
1991	600,000	731,888	1,045,499	18%	55%	3,000,000	3,659,438	5,227,497
1992	600,000	714,497	990,452	18%	55%	3,000,000	3,572,483	4,952,261
1993	600,000	697,749	942,229	18%	55%	3,000,000	3,488,746	4,711,145
1994	600,000	683,519	887,199	18%	55%	3,000,000	3,417,596	4,435,995
1995	600,000	668,933	845,695	18%	55%	3,000,000	3,344,663	4,228,477
1996	600,000	656,226	801,025	18%	55%	3,000,000	3,281,129	4,005,125
1997	600,000	643,690	752,376	18%	55%	3,000,000	3,218,452	3,761,882
1998	600,000	635,733	711,994	18%	55%	3,000,000	3,178,666	3,559,969
1999	650,000	678,543	729,107	18%	55%	3,000,000	3,131,736	3,365,111
2000	675,000	690,525	706,725	18%	55%	3,000,000	3,069,000	3,141,000
2001	675,000	675,000	675,000	18%	55%	3,000,000	3,000,000	3,000,000
2002	700,000	685,602	662,879	18%	55%	3,000,000	2,938,296	2,840,909
2003	700,000	672,159	628,917	18%	55%	3,000,000	2,880,682	2,695,360
2004	850,000	800,975	727,319	18%	55%	3,000,000	2,826,970	2,567,009
2005	850,000	786,040	693,345	18%	55%	3,000,000	2,774,259	2,447,101
2006	1,000,000	907,510	777,598	18%	55%	3,000,000	2,722,531	2,332,794

PREPARED STATEMENT OF WILBUR A. STEGER, PH.D.

INTRODUCTION

Mr. Chairman and members of the Committee:

I am distinctly honored to appear before this distinguished Committee, on a topic of undeniable national importance and particular personal interest: Preserving and Protecting Family Business Legacies. My perspective on this issue relates to the economic research I have conducted on the effect of the estate tax and related treatment of capital gains going back as far as my Harvard Ph.D. Economics dissertation almost a half-century ago, as well as numerous professional journal articles I have written since then. I, and my colleagues at CONSAD Research Corporation, the policy analysis firm I formed in 1963, are currently involved in various research projects on this topic. Moreover, I have presented briefings and advisories on this subject to almost every President since John F. Kennedy and Lyndon Johnson, including Presidents George Bush and William Clinton, as well as numerous, outstanding members of Congress. Today's session, however, stands out among the rest in its importance as an opportunity to identify problems faced by families and businesses due to the estate tax, and potential solutions, the possible reform or elimination of the estate tax and potential changes in tax treatment of capital gains, both realized and unrealized.

SUMMARY OF EFFECTS OF REDUCING OR ELIMINATING THE ESTATE TAX

There is a lengthy and complex history to deliberations regarding the estate tax and capital gains. These hearings are unique, however, since they involve discussions of the positive economic effects on family business and workers of reducing or eliminating the estate tax, and of the benefits of freeing locked-in capital markets.

First, I would like to address the issue of the magnitude of the problem. We should explore exactly who is impacted. Those in favor of keeping the tax assert, "Less than one percent of taxable estates are comprised of family-owned businesses." This assertion is based on an extremely restrictive definition for a family-owned business.

We were able to find a more accurate measure for defining the financial attributes of an estate that includes a family-owned business, the summary data that the Internal Revenue Service (IRS) has compiled from estate tax returns indicate that the assets of family-owned businesses are sizable portions of the estates reported on a substantial percentage of taxable estate tax returns. Rather than being less than 500 in a typical year, the total number of taxable estates that consist largely of family-owned businesses likely exceeds 10,000 annually.

Based on research by myself and my colleagues, we believe that important benefits would result from the reduction or elimination of the estate tax and, in the context of repeal, changing the basis for taxing capital gains. These benefits include the following:

- **Economic effects are positive**. Currently, many small business owners, and estates with non-liquid assets, must break up their business or holdings in order to raise money to pay their estate tax debts. All sides of the debate agree that this has a considerable disruptive effect on many family businesses, including farmers. Proposals to reduce or eliminate the estate tax would make it much easier for these businesses to continue to operate without undue disruption. The research my firm has conducted estimates the macroeconomic consequence of the elimination or substantial reduction of the estate tax, i.e., the extent to which these would beneficially affect jobs, national income, and economic output. While we did not consider (in that report) the revenue and economic effects of the carryover of basis, as called for in many legislative proposals, we continue to believe that the investment and liquidity-enhancing effects of the elimination or reduction of the estate tax will increase the survivability of family business and their positive effects on local and regional economies. Our research also confirms the benefits of speeding these effects, e.g., through immediate reduction or elimination, particularly if and as economic conditions worsen.
- **Revenue losses will be lower than currently anticipated**. Experts differ on the estimates of the precise revenue consequences of both eliminating the estate tax and changing the tax treatment of capital gains. Our ongoing research appears to indicate that the revenue gain from the correlate change to the carryover basis will yield annual revenue gains beginning at $5 billion and gradually rising to more than $15 billion yearly. The change in basis at death will lead to more revenue gains than are currently contemplated.
- **Approximately fifteen trillion dollars (more or less) of unrealized capital gains will become more free and fluid to serve the interests of American businesses and their workers**. We have come to know, through research and judgment [Steger, 1957; Gravelle and Lindsey, 1988; Burman, et al., 1997; Auten and Joulfaian, 2001 (forthcoming)] that there is an immense pool of accrued but yet unrealized capital gains. By my own estimates, these currently amount to as much as $15 trillion, and are growing. Proposals to transition from the stepped-up tax basis for capital gains to the carryover basis will result in increased revenues, partially offsetting the loss in estate tax revenues. The stepped-up basis will, by and large, diminish in importance with the elimination of the estate tax.
- **Preserving family businesses**. Currently, families and estate executors face a complicated set of overlapping tax rules that include the estate tax, capital gains tax, and the gift tax. Many Americans devote considerable time and re-

sources on estate planning to arrange their personal and business affairs in an attempt to minimize their total taxes at death. Unfortunately, without such planning, some estates face an unnecessarily high tax burden that hurts families and small businesses. In the ideal economic model, the simplification of the tax code that would flow from the elimination of the estate tax would result in a clearer picture of expected tax burdens at death, and free up resources now spent on navigating the maze of the tax code.

More detailed information characterizing the magnitude and composition of the effects of eliminating the estate tax and unlocking unrealized capital gains is presented in the following section.

BACKGROUND AND HISTORY

Since the middle of the last century, this subject has enjoyed an active history. Not surprisingly, during the early years of the Clinton Administration, the President's economic think-tank called for an end to the (income) tax exemption for unrealized capital gains held when a person dies. This proposal cited an ultimate revenue yield of $5 billion per year as well as enhanced equity as justifications (Shapiro, 1992). This marked the approximately fiftieth anniversary of the pathbreaking article on this subject—with a similar objective to Clinton's—by the celebrated income tax specialist and reformer, Stanley S. Surrey (Surrey, 1941).

Professor Surrey was destined to bring this important notion, and an affirmative assessment of its constitutional validity, to the attention of Presidents Kennedy and Johnson while serving as their Assistant Secretary of the Treasury for Tax Policy during the 1960s. Under President Johnson, a Treasury Department study recommended taxing gains as income on a decedent's final tax return. Then House Ways and Means Chairman Wilbur Mills, working with Surrey and myself (Steger, 1957, 1961) during this period, held committee hearings on this and closely related income and estate tax subjects (Steger, 1959; Heller, 1955). Also during this period, leading public finance economists of the day (F.M. Bator, R. Blough, J.K. Butters, R.F. Gemmill, J.K. Lintner, L.H. Seltzer, H.M. Somers, L.E. Thompson, and others) provided excellent insights into prospective economic and equity effects of taxing capital gains as though realized at death and/or disallowing the stepped-up basis.

In 1976, the House Ways and Means Committee considered alternatives to the stepped-up basis including a basis carryover and/or an additional estate tax; indeed, the 1976 Tax Reform Act enacted the carryover basis, but it was repealed in 1980. President Carter was the first President to attempt to implement the carry-over of the descendent's basis at death through Internal Revenue Service (IRS) action. The IRS attempted to implement this concept in the late seventies but was thwarted (President Carter recalls) by "difficult administrative problems" such as estimating the original basis. The IRS discontinued this program after a short trial, though I recall that President Carter believed that, with more resources and time, the carry-over of basis could, feasibly, be implemented. Presidents Nixon (through Wilbur Mills), Reagan and Bush appear to have been apprised of the revenue, economic and equity effects of the treatment of unrealized capital gains at death, though no legislative or administrative proposals for reform appear to have been set forth during this period.

Pertinent research analyses during the Clinton Administration, included:

1. A *CBO Papers* review (CBO, June, 1991), estimated three different revenue outcomes (depending on the taxing statute): a maximum of $19.0 billion over five years by including the gain (as though constructively realized) in the last income tax return of the decedent and enacting a supplemental 10% estate tax: versus a minimum of $5.2 billion over five years, by enacting a carryover of the decedent's basis.

2. The 1992 Tax Expenditures analysis (U.S. Office of Management and Budget, 1992) of the stepped-up basis, showing "outlay equivalents" of $29.8 to $36.0 billion (1990–1992) and $22.1 to $26.8 billion (1990–1992) revenue loss.

3. Congressional committee studies of the stepped-up basis, using a variety of assumptions, place the estimate in the $15 to $17 billion range.

Tax expenditure estimates by the Treasury Department's Office of Tax Analysis, based on a retrospective analysis, are indeed quite high. Conversely, the CBO estimate of revenue gain appears to be low, as explained below. Such analyses are performed using different, but reconcilable, assumptions. The estimate in *Mandate for Change* (Shapiro, 1992), for example, assumes the continuation of the current exemption for capital gains on assets willed to a spouse or donated to a charity, as well as gains in a small business or a farm, and provides additional exemptions (up to $125,000) for gains from the sale of a residence. Several considerations compound the uncertainty of such estimates, which are all much less in absolute terms than those of the last few years:

- There appears to have been an increased preference by the Clinton Administration for an indexing (for price changes) solution to the taxation of capital gains during life. While there are no reliable estimates, approximately one-half to two-thirds of all capital gains would likely remain after indexing.
- Disallowing the stepped-up basis and turning to the carryover basis, rather than the constructive realization of gains at death, appears to have been the preference of policy-makers (although, see Gravelle and Lindsey, 1988). Each of these approaches has its own dynamics relative to such important consequences as earlier realization of gains (e.g., during the decedent's lifetime).
- There is a further possibility that, to gain political acceptability for a change in the tax treatment at death, a compromise lesser rate was to have been reached regarding gains realized during lifetime.
- Were there any changes in the treatment at death, commentators believe that there would be additional small-entity exemptions, phase-in transitions, and other mitigating features.

During the 90s there have been additional, ongoing analyses by, for example, Price Waterhouse and the American Council for Capital Formation (ACCF), supplementing the CBO, Tax Expenditures, Treasury, and Congressional estimates. What is safe to say is that the variety of policy options do not merely compound the uncertainty of the revenue estimate. Rather, depending on the combination of policy changes (in terms of the specific details of each of the options), the willingness to engage in capital asset acquisitions and sales will change fundamentally, while the timing of gains and losses also changes. In economic parlance, the demand for and supply functions of capital assets will be altered.

Aside from its uncertain but clearly substantial revenue consequences, a variety of economic and equity reasons are advanced for reform of the tax treatment of assets at death (Steger, 1957, 1959, 1961; Surrey, 1941; CBO, 1992; Butters, 1953):

- Reducing the disparity between those who save through an appreciating asset and those whose income is entirely taxable (i.e., the Haig-Simons-Vickery economic concept of taxable income)
- Reducing the incentive for investors to hold assets until death to avoid capital gains taxes (the "lock-in" effect), thus diminishing (or preventing) the blocking of otherwise economically efficient investment decisions
- Assessing a tax on income at death involves adverse consequence for economic incentives and efficiency during lifetime, both for the decedent and their heirs.

And the obvious difficulties of changing the current treatment:

- The forcing of asset sales to pay taxes
- The difficulty of determining the basis of assets (particularly in closely-held businesses)
- The inequity (if there is no grandfathering) of taxing where no tax was anticipated
- Discouraging saving and taxing unreal (e.g., "inflation-caused") gains.

The Bush Administration appears to support the tax treatment at death for unrealized gains described in the Kyl-Breaux Estate Act of Tax Elimination Act of 2001. (There are similar arrangements in other bills.) The proposal allows every individual to continue to step-up the tax basis of assets in his or her estate to the fair market value at the date of death, subject to an overall limitation on untaxed capital gains of $2.8 million per individual (or $5.6 million per married couple). The per-person exemption would be indexed for inflation. The limited step-up in basis would protect small estates from any new capital-gains tax liability and reporting requirements. Such liability and reporting requirements would apply only to estates with unrealized gains in excess of $2.8 million (or $5.6 million in the case of a married couple). Other bills take different approaches, also using the decedent's tax basis in one way or another.

Currently, a number of legislative proposals contemplate the elimination of the estate tax concomitant with partial elimination of the stepped-up basis (over time, or in whole or part) for taxing capital gains. These proposals put forth a variety of alternative tax treatments that would carry over the decedent's basis, in some form, to the heirs with some schedule for phase-in.

Questions have been raised about these unrealized capital gains—considered together with the degree to which the estate tax is curtailed or eliminated:

1. What is the current magnitude of these unrealized capital gains and their distribution among asset classes?
2. What would be the revenue effects of various treatments (e.g., degree and method of carryover, phasing, grandfathering, etc.)? How would each variation

affect the current estimates of the decrease in tax revenues that would result from repealing the estate tax?

3. What would be the effect on the economy for alternative treatment, in terms of jobs and output in specific industrial sectors by state and region. How might these economic effects alter estimates of impacts on tax revenues?

4. What would be the effect on different demographic groups (e.g., income, age, family type) of each treatment variation?

My CONSAD colleagues and I have conducted a preliminary analysis using a regional econometric model and associated analytic software and interpretation of tax research results to estimate the revenue, economic, and demographic consequences of a set of "what if" realization patterns of these capital gains. This research is ongoing.

ESTIMATING CONSEQUENCES

Our study of the economic and revenue consequences of current legislative proposals is in progress: we anticipate completing our study in four to six weeks. Consider, for illustrative purposes only, that $15 trillion for capital gains (in current dollars) are created and accrued over a 25 to 30 year "generation" of taxpaying earners. This rough estimate draws upon research findings made by Steger (1957, 1959) and, thirty years later, by Gravelle and Lindsey (1988) that: (a) on average, only 3.1 percent of the stock of accrued gains are realized in any given year, over a 25-year period; and (b) that realized capital gains in each year average only 24 percent of the total capital gains accruing to the household sector in that year. These economists, and others, believe that the majority of capital gains, under the current system (with a stepped-up basis), are never realized, but, instead, are passed on to heirs with a step-up in basis or given away in a tax-free transaction. It would seem that, were unrealized gains taxed at current capital gains tax rates, either at death or to heirs over their lifetimes, a yearly equivalent of many billions of dollars in additional taxable gains might result. How would these complement the current revenue of approximately $90 billion for realized capital gains?

Of course, many new questions are now raised. With proposals for exemptions, a degree of grandfathering, and/or the partial disallowance of the stepped-up basis, the questions include: Might there be another $1–2 trillion realized during lifetime (subject, of course, to the specific exemption levels, capital gains regulation changes, income tax rates, etc.)? Would the type and quantity of capital assets (e.g., degree of risk) fundamentally change? Would there be many unanticipated, inequitable consequences? Would there be a number of formerly non-taxed estates (e.g., both estate and income tax) subject to one or both taxes? Would there now be a sizable increase in the number of lower income decedents subject to a tax at death?

CONSAD is currently involved in a new study of the economic and revenue consequences of current alternative proposals that will be completed in four to six weeks. The study is addressing the following issues related to the reduction or elimination of the estate tax and its capital gain correlates:

- Federal government revenue changes (from both the income and the estate tax),
- Changing patterns of capital gains realization,
- Changing acquisition and disposition patterns of capital assets.

The possible economic and fiscal impacts range from relatively minor to significant. The purpose of our research is to narrow the range of prospective outcomes, such that they will provide information helpful in distinguishing among alternative policy options.

In addition, though, a study of the positive aggregate economic effects of the elimination of the estate tax (CONSAD, 2001) which employed the most widely utilized regional econometric model, found that reducing or repealing the estate tax would free up substantial resources for alternative purposes. The heirs of people who die would inherit additional funds that otherwise would have been collected as taxes. Also, the resources that people now expend (i.e., planning costs) to mitigate the consequences of the estate tax would be released for other uses. We also discovered that the aggregate gains in value added in the majority of U.S. industry substantially exceeded the decreases that would occur in the few industries that would experience decreases in demand for their services due directly or indirectly to the reduction or repeal of the estate tax. This research also established the additional benefit, particularly in tight economic times, of making the reduction or elimination take place as quickly as possible, including immediately. Our ongoing research is anticipated to alter these estimates only slightly while, at the same time, realizing increased revenues to the Treasury.

INTERIM RESULTS

The combination of the estate tax and the stepped-up basis at death determine the total tax paid by estates and their heirs. So, alternately will a system with no tax (at death) on estates and a carryover (primarily) of basis. However, just as it took time for the current system to settle into a relatively predictable pattern, it will take years for any new system to settle into its routine.

The implementation of the stepped-up basis for capital gains taxes resulted in a reduction in Treasury revenue, reducing, in essence, the revenues from the estate tax. Similarly, the carryover of basis will increase Treasury revenues, replacing, to an extent, the loss of the estate tax revenue.

We have made a rough estimate, to be refined during our study in the next several weeks, of the extent of this replacement of estate tax revenue loss. It falls primarily into two categories:

1. Increased realization by some of those currently in the 50 (plus) age bracket who, until now, have been holding appreciated assets, waiting for death to provide their heirs with a stepped up basis. We refer to these as "unlocked seniors." We could anticipate this phenomenon will continue for 20–30 years following the repeal of the estate tax and change to the carryover basis.
2. The much larger revenue replacement will be the result of the loss of stepped-up basis by heirs of these decedents. Heirs of decedents in year 1 will (generally) realize many (but not all) of their inherited gains sometime during their lifetime (say, a 30–35 year period) and pay a significantly larger tax than they would have had the stepped-up basis obtained. We refer to this group as the "carried-over heirs."

Unlocked seniors—Our interim estimates of revenues gained from earlier capital gains realization from some "unlocked seniors" were produced for four household groups ranging from ages 65 to 85 and over. The data consisting of household characteristics (i.e., age, wealth, assets, net worth, etc.), and death and life expectancy rates, were collected from the Census Bureau's Statistical Abstracts, Current Population Reports and Household Net Worth and Asset Ownership Studies. The earlier realization coefficients, applied to the wealth of these wealthy seniors, were derived for an as-of-yet unpublished article by two Treasury researchers (Auten and Joulfaian, 2001) which estimated capital gains realization rates using a two stage tobit regression in their paper "Bequest Taxes and Capital Gains Realizations." Auten and Joulfaian calculated coefficients for realizations that we applied to the total net worth estimates. First, we calculated total realized gains for the life expectancy of the households according to these estimated coefficients ($23.2 billion). Then we assumed that households would act as they did at age 65 with no estate tax, retaining their coefficient until death, and calculated total realized gains for their life expectancy ($24.9 billion). The difference of $1.7 billion annually is the estimated increase in realized capital gains (with the elimination of the estate tax) by these "unlocked seniors."

Carried-over heirs—The most recent estimate of additional revenues resulting from heirs who would now be subject to the carryover, not the stepped-up basis (Congressional Research Service, 2000), places the range between $1–$4 billion annually. We believe it will be significantly higher than this, though we are unclear as to the CRS methodology.

To estimate the effect of the elimination of the stepped-up basis on the capital gains taxes paid by the heirs of decedents on the accrued capital gains in their inheritances, we first apportioned the total capital gains that were realized in 1997 between the portion of the population that were required to file estate tax returns and the remainder of the population. The apportionment has been based on the estimates developed by Burman and Ricoy for the portion of capital gains realizations in 1993 that were performed by families in specific income categories.

We then divided total capital gains realized by families in each income category by the estimated number of households in that income category. The resulting ratio was next multiplied by the number of decedents in that population group (i.e., the number of people who filed estate tax returns in 1997, and the number of other people who died in 1997). This calculation is based on the assumption that the heirs will realize the capital gains on their inherited assets in approximately the same manner as realizations which were occurring in 1993 among people in their (or, more accurately, their benefactor's) income category, but will now be liable for payment of capital gains on those realizations. Previously, no capital gains taxes were owed on these amounts because of the step-up in the basis for the inherited assets. We then estimated that capital gains taxes would be collected on those realizations at the effective (1997) tax rate of 21.7 percent.

These calculations produced the estimate that capital gains tax revenues would increase by approximately $4.3 billion in the first year after the estate tax is repealed, if total capital gains realizations in that year were equal to those observed in 1997. Of that amount, $3.6 billion would be paid by the heirs of decedents for whom estate tax returns would have been filed, and the remaining $0.7 billion would be paid by the heirs of other decedents. Significant additional tax revenues (e.g., $12 to $20 billion, annually) would be obtained in subsequent years as additional portions of the accrued capital gains in the inherited assets are realized, and as additional decedents bequeath assets with accrued capital gains that previously would have been exempted from capital gains taxation due to their step-up in basis. Thus, the total increase in capital gains tax revenues in any year after repeal of the estate tax would be several times larger than the amount estimated for the first year after repeal. A method for estimating that total increase is currently being developed and results will be available in four to six weeks.

Total revenue gains—Across these two components, our preliminary estimate is that revenue gain will exceed $5 billion annually in the first year and, then, by the fifth year rise to more than $15 billion annually for many years.

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Prepared Statement of John Sumption

Mr. Chairman, members of the Committee, my name is John Sumption. I am a grain and livestock producer from Frederick, South Dakota, and a member of the South Dakota Farmers Union. It is a pleasure to appear before this committee today, on behalf of the National Farmers Union, to discuss estate taxes from the perspective of family farmers and ranchers.

I was born in 1948, and grew up on a family farm. I began farming in 1966, the year I graduated from high school, when I purchased 470 acres. My wife Margaret and I were married in 1971. At that time, we had laying hens, sheep, hogs and cattle. We raised feed for our livestock and produced some wheat that was sold as a cash crop.

Of our five sons, Christopher, Eric, Mark and Taylor farm with us at the present time. All have attended state universities or technical schools and taken courses concerning various aspects of agriculture. Our youngest son, Warren, who currently works in Sioux Falls, would also like to return to the farm.

Our operation consists of 1700 acres that I own with my wife and an additional 1600 acres owned by our sons. We produce wheat, corn, barley, soybeans, oats, and sunflowers, and maintain a herd of 700 beef cattle. We also perform custom planting and harvesting for others to help support our investment in equipment.

A year ago, Margaret and I reviewed our estate plan. While most of the people I know who run family farms—my friends and neighbors—are already exempt from paying any estate taxes, Margaret and I have been fortunate, and due to our prosperity we are not in this group.

Our farm is worth roughly $2 million. Under the existing estate tax provisions, our children would have to pay an estate tax upon our deaths. In order to transfer our farm to our children, without creating a financial hardship for them, we developed an estate plan built around living trusts. With our planning, we hope our children and grandchildren will be able to reap the benefits of our hard work and will be provided for in the future.

However, we don't know what the future will hold. We plan to review our estate plan every year, for many reasons, but most importantly, because of increases in property values that could make estate taxes on my farm practically unavoidable under current law.

I understand that several alternatives are under discussion to address problems with federal estate tax laws. These proposals range from gradual rate reductions that end in complete repeal after a number of years, to an approach that would provide immediate relief to families, small businesses, and farmers and ranchers who have been fortunate enough to experience growth in the net value of their holdings.

In my view, the most important elements that should be considered are increasing the level of the tax exemption and simplifying the qualification process as soon as possible. The current exemption fails to adequately account for the growth in asset values of those families who have saved or invested in their own businesses. In addition, immediately expanding the exemption level will reduce the need to develop and maintain estate plans for the purpose of reducing or avoiding the tax. Finally, considering the average age of farm operators, and the fact that some proposals would not remove anyone currently subject to the tax from potential liability for many years, an increase in the exemption now is extremely important.

To me, reforming the federal estate tax by immediately raising the exemption levels, rather than repealing the tax after many years, makes sense for family farms, regardless of any impact it may have on the federal budget surplus or other tax reform measures. National Farmers Union supports increasing the estate tax exemption to cover estates valued at $4 million per person, which results in an exemption of $8 million per couple. That level would certainly take care of my farm, as well as any estate tax hardship faced by the farmers and small business owners I know.

Mr. Chairman, I am not an expert on tax law, but I know about family farmers. They are my friends and neighbors. They are not worried about estate taxes, because, for the most part, they don't have to pay them. They are worried, however, about the prices they receive for their crops and livestock, about good public schools for their kids, about local community services, paying for prescription drugs and being able to pay their bills in retirement. And, of course, they are always worried about the weather.

I fear we may not be able to do the things we want and need for our communities if we repeal the federal estate tax. To me, it doesn't seem responsible to eliminate the estate tax for everyone, including billionaires, when they don't need the help.

A more targeted approach that helps families better address this issue now, while retaining more resources for other needed public investments to improve our future, seems a more practical and appropriate course of action.

Mr. Chairman, thank you for the opportunity to speak with the Committee today about estate tax reform. I look forward to responding to any questions you or your colleagues may have.

PREPARED STATEMENT OF STEFAN F. TUCKER, ESQ.

Mr. Chairman and Members of the Subcommittee on Taxation and IRS Oversight:

My name is Stefan F. Tucker. I am a member of the District of Columbia Bar and a partner in the law firm of Venable, Baetjer, Howard & Civiletti, LLP, of Washington, D.C. and Baltimore, Maryland.

I am appearing before you today as a private practitioner, with a heavy emphasis in my practice as a lawyer for and counselor to entrepreneurs and high-wealth individuals, both as to their income, estate and gift tax planning and as to the structuring of their business and investment strategies, including the acquisition and disposition of assets.

I very much appreciate the opportunity to discuss with you the potential impact of radical changes in the present Federal estate and gift tax regime, including particularly the move from full stepped-up basis to part stepped-up and part carryover basis.

I. OVERVIEW

A. Current Law.

All U.S. citizens and residents are subject to Federal estate and gift taxation on their worldwide assets. As a result, transfers of property of any type, whether located in the U.S. or abroad, trigger either estate tax or gift tax, subject to certain exclusions and credits.

The lifetime "applicable credit" generally allows each taxpayer to make the first $675,000 of such transfers tax-free. (The applicable credit is presently scheduled to increase gradually to $1 million by 2006.) In addition, each taxpayer is permitted to make tax-free gifts of $10,000 ($20,000 for married couples who elect to split gifts) to any one person each year; and certain "qualified transfers" for educational or medical expenses are not considered gifts.

In addition to the Federal estate and gift tax, a generation-skipping transfer tax (the "GST tax") applies to transfers or distributions to persons who are treated as two or more generations below the generation of the transferor (a "skip person"). The GST tax is imposed at a flat rate of 55 percent. However, every U.S. citizen and resident has a lifetime GST tax exemption, currently $1,060,000, which permits transfers to skip persons equal to that amount free of GST tax.

B. Current Proposals.

As of the 1st of March of this year, 18 bills had been filed with respect to the reform of the Federal estate and gift tax. Of these, nine bills had been filed in the House, and nine bills had been filed in the Senate.

The bills represent a range of proposals, including particularly the following:

(1) Immediate repeal of the estate and gift tax (S.82, S.100, S.275 and H.R. 86, H.R. 130, H.R. 153, H.R. 193, H.R. 246, H.R. 330).

(2) Phased-in elimination of the estate and gift tax (S.31, S.35, S.83 and the proposed Dunn-Tanner bill, as well as President Bush's proposal).

(3) Increase in the exclusion, in some cases combined with a decrease in the estate and gift tax rates (S.9, S.84, S.179 and H.R. 42, H.R. 88, H.R. 543).

Those categories of bills which propose to repeal the estate and gift tax, either immediately or through a phase-out mechanism, open a Pandora's box of issues. Some of these will profoundly impact the estates of those who die during the phase-out period. The proposed changes make planning for such persons and protections for their families and donees and heirs particularly difficult. Other of these changes will severely impact the backbone of our income tax system and its voluntary nature.

This testimony will emphasize (1) issues and questions regarding carryover of basis or a part stepped-up basis/part carryover basis system, (2) opportunities and incentives to "game" the Federal income tax regime if there is no Federal estate or gift tax, and (3) the effects on the states.

II. CARRYOVER BASIS ISSUES

A. Determination of Basis.

Property acquired by gift. The basis of property acquired by gift is its basis in the hands of the donor ("carryover basis"), increased by any gift tax paid, but not beyond the property's fair market value at the time of the gift. For gifts made after December 31, 1976, the increase in basis for gift tax paid is only as to the ratio of (1) the gift tax paid to (2) the net appreciation in value of the gift (that is, the excess of the fair market value of the gift over the donor's adjusted basis) as compared to the amount of the gift.

Illustratively, if the gift is stock or securities having a value of $100,000 and a cost basis of $20,000, and if the gift tax paid is $45,000, then $36,000 (or 80% <$80,000/$100,000> times $45,000) will be the increase in the basis of the stock. Thus, the adjusted basis of the stock in the hands of the donee is $56,000 (or $20,000 plus $36,000).

Accordingly, in computing any gain or loss on a subsequent sale or other disposition of the transferred property, the donee uses the donor's basis (as so increased by the applicable gift tax paid).

The Internal Revenue Code (the "Code") contains a provision for gifts of built-in loss property to prevent a donor from transferring losses to the donee. Thus, a donee cannot use the donor's basis for purposes of determining subsequent losses where the donor's basis exceeds the property's fair market value (i.e., the property contains a "built-in loss") at the time of the gift. Rather, the basis of the property for purposes of computing the donee's loss is the lesser of the property's fair market value on the date of the gift or the donor's basis.

If the property is sold at a price greater than the fair market value at the date of gift, but less than the donor's basis, then neither gain nor loss is recognized on the transaction. The built-in loss is never utilized. If the property is sold at less than the property's fair market value at the time of the gift (i.e., the property continues to decline in value after the gift), the donee can use the property's fair market value at the time of the gift (but not the donor's higher basis). Similarly, if the property appreciates so that its value exceeds the donor's basis, the donee can use the donor's basis for purposes of calculating any gain.

In effect, these rules interlock the Federal gift tax and the Federal income tax.

Property acquired from a decedent. Under current law, the basis of property acquired from a decedent is the fair market value of the property as of the date of the decedent's death (or, if the decedent's executor so elects, the alternate valuation date six months after the decedent's date of death, but only if the election decreases the decedent's gross estate and the taxes imposed thereon). If property has appreciated as of the decedent's death, that appreciation is not subject to income tax. Of course, the property, including any appreciation, is subject to estate tax.

Because property generally tends to appreciate during a decedent's lifetime, this new basis is usually referred to as a basis "step-up." Thus, the heir or legatee has a "fresh start," rather than a basis that is determined by reference to the decedent's basis in the property. (Concomitantly, if the asset decreased in value during the decedent's lifetime, there would be a basis "step-down.")

In the case of property held jointly by the decedent with another person with right of survivorship, the entire value of the property is included in the decedent's estate, unless it is established that the portion of the property owned by the other party was not acquired from the decedent for less than full consideration. If the joint owner is the decedent's spouse, one-half of the value of the property is included in the decedent's estate (at least in common law states). In either case, the basis of the property so included and passing to the surviving joint owner equals its date of death fair market value (unless the alternate valuation date is elected).

B. Liabilities in Excess of Basis.

Assume that the decedent owns a piece of improved real property solely in his individual name. The total cost was $1,000,000; the fair market value on the date of death is $5,000,000; there is debt encumbering the property in the amount of $4,000,000; and the adjusted basis on the date of death is $400,000.

Under the current Federal estate tax laws, the $1,000,000 net fair market value of the real property [that is, $5,000,000 less $4,000,000 of debt] would be included in the decedent's estate. Assuming that the decedent's estate is in the 55 percent estate tax bracket, the estate tax attributable to this real property is $550,000, due as a consequence of the decedent's death. This estate tax may not be payable at such time due to the utilization of the marital deduction, if left to the decedent's spouse, or the charitable contribution deduction, if left to an eligible charity. Alternatively, the estate tax due may be covered by other liquid assets (if the heirs desire to continue to hold the real property), or the proceeds of the sale of the real property (which, based on the facts, would essentially produce a net $1,000,000 because there is no Federal income tax due on the sale, due to the step-up in basis to $5,000,000 on death), or through other sources of liquidity, such as loans secured by this or other assets or life insurance proceeds.

Contrast the carryover basis regime—under which the decedent's heirs would acquire the same property, but would have an adjusted basis of only $400,000 (the decedent's basis). On disposition of the real property, the heirs would realize a taxable gain of $4,600,000 (that is, the $5,000,000 of fair market value less $400,000 of adjusted basis, without taking any cognizance of the debt). The Federal income tax would range from $920,000 (if none of the gain were attributable to unrecaptured depreciation) to $950,000 (assuming that the $600,000 difference between the total cost of $1,000,000 and the adjusted basis of $400,000 were attributable to unrecaptured depreciation).

While the income taxes due in a carryover basis scenario could be covered by the same sources as above, it must be noted that, under these facts, the Federal income tax due ranges from 167 percent to 172 percent of the Federal estate tax. Incredibly, the difference in the tax payable is infinite if the real property goes to the spouse, who then sells the same, inasmuch as the combined Federal estate and income tax attributable to such scenario under current law would be -0-, whereas the Federal income tax alone in a carryover basis regime would range between $920,000 to $950,000.

C. A Focus on Add-Ons to Adjusted Basis.

Under the current Federal income tax law, the basis of property starts with its cost, whether acquired by purchase or by construction or fabrication. This cost is increased by related expenditures, such as commissions paid, title search costs, legal and related costs attributable to acquisition and certain direct and indirect costs of producing or acquiring the property. At later points in time, the basis of the property is further increased by rehabilitation and replacement costs, as well as overhaul and similar costs incurred in adapting the property to a new use or in significantly extending the useful life of the property.

There are other add-ons to the basis of property. Under the current law, for example, and as explained above, the basis of the property is increased in the hands of the donee by certain gift taxes paid with respect to such gift.

Likewise, when an estate or trust distributes an interest in a passive activity, then, under Code Section 469(j)(12), the basis of the interest is increased by the passive activity loss carryover allocable to such interest, and the losses are no longer allowable as a deduction, whether against passive income or on disposition of that property.

When considering whether to move from a combined Federal estate and gift tax/ income tax regime to a solo Federal income tax regime, a number of other potential income tax basis adjustments need to be analyzed, with the decision on each being whether it is to become a basis adjustment or a continuing income tax carry-forward. For under all circumstances each of these items must, in a fair and equitable solo Federal income tax regime, be one or the other. Among these items are the following:

(1) Charitable contribution carry-forwards, under Code Section 170(d), with the concomitant consideration as to whether the carry-forward should continue to be limited to the next succeeding five taxable years, and, further, whether carry-backs should be instituted.

(2) Net operating loss carryovers, under Code Section 172(b), with the concomitant consideration as to whether there should be a 20-year limitation on the carryover.

(3) Amortization deductions with respect to amortizable Code Section 197 intangibles, as to which the adjusted basis is amortized over the 15-year period beginning with the month in which the intangible was acquired.

(4) Investment interest carry-forwards, under Code Section 163(d), which presently have an unlimited time period.

(5) Capital loss carryovers, under Code Section 1212(b), which presently have an unlimited time period.

With regard to the foregoing, it would be counter-intuitive to provide for carryover of basis on death without permitting the heirs to continue to utilize the carryovers and carry-forwards to which the decedent was entitled. If these unused carryovers and carry- forwards were to become adjustments to basis, then the new system will impose the painstaking task of determining those assets the bases of which are to be adjusted and the allocation of such adjustment among such assets. Is this to be an elective procedure, through the executor, trustee or other personal representative or, in the absence of the same, the heirs? Whether or not elective, will there be a tiering (for example, first to capital assets, then to investments held for productive use in a trade or business, then to inventory and then to personal property), or a tracing (for example, which assets produced which carryover or carry-forward), and/ or a proportional application (such as in the ratio of the various assets or categories of various assets in the decedent's estate, based on a fair market value determination)? Please note that the use of any or all of these calculations requires significant record keeping, record retention and tracing, as will be noted time and again in this discussion.

Furthermore, what about the impact of the payment of state or local estate, inheritance, succession or other taxes in lieu thereof? Clearly, one can see the logic in adding these taxes to the basis of the decedent's assets for Federal income tax purposes. [In fact, to the extent that the state estate, inheritance, succession or other taxes in lieu thereof were attributable to net appreciation in value of property, this increase in basis was provided in the carryover basis provisions of (now repealed) Code Section 1023 by the Tax Reform Act of 1976.]

Again, through what mechanism(s) would state estate taxes be added to adjusted basis? On the other hand, it would be somewhat simpler to trace state inheritance taxes because that tax is generally imposed on the recipient of the property. In that event, one need only be concerned with the allocation of this tax among the assets received.

D. Determining and Tracing Historic Adjusted Basis.

It can be extraordinarily difficult to trace the historic basis of many assets, such as personal property held for generations within families for reasons of family history or affection, rather than because the property was not marketable. Recognizing such difficulty, a step-up in basis to fair market value as of March 1, 1913 was essentially sanctioned at the inception of the Code in 1913. A similar reconciliation was done as to gifts or transfers in trust before January 1, 1921.

Again, in order to prevent retroactive adverse effect from the adoption of carryover basis, a "fresh start" to December 31, 1976 was to be afforded taxpayers with the carryover basis provisions of the Tax Reform Act of 1976, based on the application of (1) the ratio of the number of days held prior to January 1, 1977 to the entire number of days held by the decedent as of the date of death to (2) an increase to the fair market value of the relevant property, subject to certain adjustments.

The current Regulations applicable to determining the basis of property in the hands of a donee clearly take into account the difficulty of ascertaining such basis in many situations. Under Treas. Reg. §1.1015–1(a)(3), if "the facts necessary to determine the basis of property in the hands of the donee or the last preceding owner by whom it was not acquired by gift are unknown to the donee," the district director of Internal Revenue is supposed to ascertain the property's basis; and, if the district director finds it impossible to do so, then the basis is considered to be "the fair market value of such property . . . as of the date or approximate date at which, according to the best information the district director is able to obtain, such property was acquired by such donor or last preceding owner." With all due respect to all present and prior district directors, neither donors nor donees will, under the best or worst of cases, put themselves into such straits. This makes for a lot of educated guesstimates of fair market value, using the best information available under the circumstances.

One must perforce compound this difficulty of ascertaining historic basis generally, which has not been a real problem on a practical basis in a Federal estate and gift tax regime that provides a stepped-up basis on death, with the four horsemen of the carryover basis apocalypse—(1) tracing the cost per asset, (2) tracing the dates of acquisition of multiple assets (*e.g.*, dividend reinvestment plan stock acquisitions, stock splits and dividends, spin-offs of corporate subsidiaries), (3) record keeping and retention (query—notwithstanding our increasingly "paperless society," will our reforestation effort meet the pace of tree destruction for paper records?), and (4) reporting requirements.

Examining only the third of these horsemen—recordkeeping and retention, consider this simple example:

> Decedent A dies on December 31, 2004, with $10,000,000 of stock in Corporation Y, acquired on many different dates, not taking into account a number of stock dividends or splits. (This is decedent A's sole asset and under the law then in effect there is a step-up of basis on $2,800,000 of the stock and no step-up, but a carryover of basis, as to the remaining $7,200,000 of the stock.) Decedent A has five heirs, C, D, E, F and G, with all five being grandchildren of A. Each of C, D, E, F and G acquires 20 percent of A's estate, and each holds the stock in Corporation Y until his or her death, which occurs from 30 to 55 years later. Each of C, D, E, F and G has sufficient other assets for his or her own step-up of basis on $2,800,000 of assets (or whatever the magic number is then). C dies 42 years later, with 10 heirs.

How do the heirs of C trace basis? Was C required to retain the records for the 42 years from A's death to her death? Why would a taxpayer retain records so that those records could be used against that taxpayer, to prove a lower tax basis? This is counter-intuitive! What would be the penalties imposed, and on whom? Would we want the Revenue Service to be the intrusive "Big Brother" here, annually or at some other period of years requiring record production? Surely not!

Some have suggested that perhaps the burden of retaining such records—for decades and perhaps centuries—should be imposed on the Revenue Service, as the central repository. Other than perhaps as a means of filling up the thousands of empty and abandoned stores, office buildings and silos in the central cores of the cities and towns in the Rust Belt and Farm Belt, at an enormous rental cost to the Federal

Government, there cannot be any justification for same. In carrying the burden of proof of proving the negative—the lower carried over basis of an asset or a fractional piece of an asset, the Revenue Service may be no better at tracing cost than the taxpayer. And then what about acts of God, such as tornadoes, floods, fires and the like?

E. The Interface between Stepped-Up and Carryover Bases.

As can be seen by the immediately preceding example, the combination of stepped-up and carryover bases on death will add incredible layers of complexity to an Internal Revenue Code already in sore need of real simplification.

The actuality and extensive and intensive reach of this combination of stepped-up and carryover bases on death will surely make the current estate and gift tax system look like a model of simplicity. And that is said by one who believes that it is considerably more difficult to understand the need for and operation of the GST tax than it is to solve the Middle East controversy, or the true meaning of Stonehenge.

Return once more to the dreaded four horsemen of the carryover basis apocalypse. Starting with the first of these—tracing the cost per asset, imagine the intense and detailed records to be retained from generation to generation. Will each taxpayer be required to retain all purchase records on all assets—real, personal or mixed, tangible or intangible, present or future, choate and inchoate—for his or her lifetime? And then will each succeeding generation be required to retain its records and those of each preceding generation, so long as any asset has a carried over basis? Will each taxpayer need to keep all receipts and all VISA, MasterCard, American Express, Discover and other credit card statements?

Move to the second of the horsemen—tracing the dates of acquisition of multiple assets. If you own mutual fund shares, where there is a mark-to-market each December 31, think about the relative complexity there. Move on to stock splits and dividends, spin-offs and split ups, mergers and consolidations, and then move over to non-recognition transactions, such as contributions to and distributions from partnerships, contributions to corporations and like kind exchanges of real and personal property.

The third horseman—record keeping and retention—will for many require more outside assistance, at a far greater cost, than occurs today. Again, this would be due in large part to the need potentially to produce these records to an Internal Revenue Service Agent or other authority years or decades or generations after the asset, or a fraction or portion of the asset, was acquired.

Now, onto the scene gallops the fourth horseman—reporting requirements. In order that the Revenue Service and the states (as the partners or dependents of the Revenue Service) will have full knowledge and information, it is logical to assume that more—yes, significantly more, not a modicum or iota less—returns (denominated "information returns," not "tax returns") will be required to be filed.

In today's world, no Federal estate tax return need be filed for an estate (including past gifts in excess of the annual $10,000 exclusion or transfers not considered taxable gifts) of $675,000 or less, moving gradually to $1,000,000 in 2006. That is because Congress, with wisdom, decided that such amount was not to be taxable and, importantly, in a universe of stepped-up basis for all assets, that there is no need or desire to trace these assets.

However, in a world of combined stepped-up basis and carryover basis, there will be every need to trace, and those well below any magic number (whether $1,000,000 or $2,800,000 or any larger number) will still see the need to file, in order to be able to prove stepped-up bases at a much later time or times.

Following closely behind the four horsemen are the twin specters of valuation and allocations of stepped-up basis among assets. If a decedent's estate is close to the magic number of, say, $2,800,000, there is every incentive to keep it at or below that number.

> Illustratively, if the decedent has an asset with a potential fair market value of $200,000 to $400,000 but a zero adjusted basis, and the use of $200,000 would leave the estate at $2,800,000, there is simply no advantage to valuing the asset at $400,000 (or $200,000 more), because the basis is $200,000, whether or not the extra $200,000 of value is reported; and any sale at a price above $200,000 has exactly the same tax consequences.

Finally, how are stepped-up basis and carryover basis allocated among assets? Assume that the executor has the ability to elect however he, she or it wishes. Will all basis be allocated away from assets not to be sold, such as art, vacation homes, collectibles and the like? Will stepped-up basis be tiered, such as first to capital assets, then to assets held for productive use in a trade or business, then to inventory, and then to ordinary income items?

Where do IRAs, 401(k) and similar plans and the like fit into this picture? Today, these items of so-called "income in respect of a decedent" do not receive a stepped-up basis at death. For decades, taxpayers were urged to save for their retirement through such and similar vehicles. Now the taxpayer with stock in his or her own name will receive a step-up in basis, and the taxpayer with stock in his or her IRA, 401(k) or similar plan will not. That was acceptable when there was a Federal estate and gift tax regime, so that all such assets were subject to the estate and gift tax. That, however, does not seem acceptable where the taxpayer with such assets in his or her name will escape income tax due to the stepped-up basis, but the taxpayer with such assets in his IRA or 401(k) will not.

How will assets with built-in losses be treated? Will the donee or heir be permitted to carry over the basis, or will a fair market value basis apply, or will some combination be applicable?

As can be seen, the resulting complexity will take its toll on taxpayer comfort and confidence. It must be remembered that our tax system relies heavily on the willingness of the average taxpayer voluntarily to comply with his or her tax obligations and record keeping and retention requirements. Three years of record retention for the greatest number of American taxpayers is an acceptable burden; three generations of such record retention is implausible, if not impossible.

F. When Is There a "Sale or Disposition?"

A key question under the proposed carryover basis system will be what constitutes a sale or disposition triggering gain recognition.

In general, the amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is relieved as a result of the sale or disposition. Thus, determining whether a "sale or other disposition" has occurred will be significant, as it will determine when the built-in gain in appreciated property (or property with liabilities in excess of basis) must be recognized.

Determining whether a sale or other disposition has occurred may be difficult. A disposition would generally be considered to have occurred when the property has been sold. This raises the question as to whether death constitutes a sale or disposition for gain recognition purposes. That is, does the death of the property holder constitute a disposition of the property by the decedent's estate?

Rather than hold property in their individual names, some taxpayers hold their assets through revocable trusts that become irrevocable upon their deaths. These revocable trusts are treated as "grantor trusts," and are disregarded for income tax purposes. Thus, transfers to a revocable trust during the grantor's lifetime are not treated as dispositions for income tax purposes, even if the property has liabilities in excess of the grantor's basis.

The grantor trust status of a revocable trust terminates on the grantor's death, whereupon the trust, now irrevocable, becomes a separate taxable entity. Upon termination of the grantor trust status, the grantor is treated as transferring the assets to the irrevocable trust for income tax purposes.

Under current law, because the property in a revocable trust is included in the grantor's estate, the property receives a step-up in basis upon the grantor's death. As a result, no gain is triggered under current law on the deemed transfer to the now-irrevocable trust. In a carryover system without any basis step-up, the "deemed transfer" to the now-irrevocable trust might require that gain be recognized, even though technically there has been no disposition.

Alternatively, a disposition might be deemed to occur only when the appreciated property is distributed to the heir or legatee (or the beneficiary of the decedent's trust), particularly where the distribution is in satisfaction of a fixed dollar amount (a "pecuniary bequest"). Under current law, a trust or an estate recognizes gain whenever appreciated property is distributed in satisfaction of a pecuniary bequest. Thus, a $5,000 bequest to the decedent's grandchild, unless satisfied with cash or another asset with a basis equal to $5,000, will trigger gain to the estate or trust. Without a basis step-up, there is a far greater possibility that such distribution will trigger gain. The same result will obtain for marital deduction bequests that are computed using a pecuniary formula and satisfied using appreciated property.

Alternatively, any distribution by a trust of property subject to a liability in excess of the property's basis might trigger gain. The distribution need not be in satisfaction of a pecuniary bequest in order for this result to obtain. Rather, if the distribution is treated as a "sale or other disposition," the mere relief of the liability might be treated as consideration for the distribution, requiring the estate or trust to recognize gain. This will force the recognition of gain even though the decedent's heirs never dispose of the property and, in certain cases, may compel that the property to be sold in order to pay the related Federal income tax. This is precisely the type of "forced sale" that the repeal of the estate tax would presumably be intended to prevent.

Neither the decedent's death nor the distribution from the decedent's estate or trust should constitute a disposition. Rather, a disposition should occur only when the distributed property is subsequently sold or otherwise disposed of by the heir, legatee or trust beneficiary; or, if the property is transferred in an otherwise non-recognition event, only when sold or otherwise ultimately disposed of.

What would the result be if the heir disclaimed an interest? Would that disclaimer be treated as a sale or other disposition, triggering gain? Surely, one would not expect the disclaimer to trigger gain when the disclaimer is considered only a by-pass, not a transfer.

III. GAMING THE SYSTEM

The repeal of the Federal estate and gift tax, with the substitution of a part stepped-up/part carryover basis system, presents numerous opportunities and incentives to "game" the income tax regime. One cannot blithely assume that the absence of any Federal estate or gift tax will make taxpayers happy to pay income tax on sales or dispositions of carryover basis assets.

A. Shifting Basis by Gift.

Taxpayers may be motivated to "swap" assets to produce the highest after-tax benefit. For example, assume Aunt Nelly owns high-basis real property and her high-tech nephew owns low-basis stock. Both the real property and the stock have the same fair market value. However, nephew is in the highest marginal Federal income tax bracket, while Aunt Nelly pays tax at the lowest marginal rate (in large part because most of her income comes from tax-free municipal bonds).

If nephew needs to raise cash, he can give his low-basis stock to Aunt Nelly in exchange for (but not tied to) a gift of her high-basis real estate, all without incurring any gift tax, and avoiding any immediate income tax (in the absence of a finding of a step transaction or taxable trade of assets). Nephew can then sell the real estate, thereby retaining more of the sales proceeds because the amount of his capital gain is lower. Under the right circumstances, both Aunt Nelly and her nephew may be better off as a result of these "gifts," and only the fisc suffers.

B. Tax Shelters—Entity and Individual.

Congress continues to consider whether to legislate on individual and entity income tax shelters. As we have moved from one Administration to the next, the Treasury and Revenue Service appear to remain concerned about these shelters.

In the meantime, like amoeba, the shelters seem to multiply by dividing. As one side of the tax shelter envelope is squeezed by unfavorable judicial rulings, Temporary and Proposed Regulations, I.R.S. Notices and Announcements and Revenue Rulings, new shelters transmogrify and morph at the other sides of the envelope. Thus, if the Revenue Service holds that a transaction fails because factors L, M and N exist, the next version features P,Q and R. To paraphrase Sir Walter Scott, "O what a tangled web we weave, when first we practice to tax relieve!"

If all of these tax shelters (now known, euphemistically, as "strategic planning" products) are being marketed today to corporations, business entities and wealthy individuals by accountants, lawyers, investment bankers, financial advisors and others, just imagine what will happen in a world where there is no Federal estate or gift tax, but only an income tax. Without the estate and gift tax, taxpayers will devote even more resources to acquiring and utilizing such shelters, and the demand for these schemes will increase exponentially.

Assume that a taxpayer inherits stock with a fair market value of $1,000,000 and zero adjusted basis. Will that taxpayer actively seek, and be marketed, alternatives to paying Federal income tax on a long term capital gain of $200,000? And what if that asset were instead a collectible, as to which the Federal long-term capital gain tax would be $280,000? And what if that stock were worth $10,000,000 with a zero adjusted basis, so that the capital gain tax would be $2,800,000?

C. Charitable Contributions.

Much has been written about how repealing the estate tax could impact charitable contributions. The impact may prove even more unfavorable if the repeal is coupled with the loss of a step-up in basis.

The Internal Revenue Code permits individuals who itemize deductions to deduct, with certain limitations, the value of property donated to certain "qualified" charitable entities. The amount of the deduction—both in terms of the value to be used in determining the deduction and the percent of that value that may be deducted in any given year—depends upon the type of property contributed and the nature of the donee organization.

For example, taxpayers are permitted to deduct 50 percent of their contribution base (essentially, their taxable income) for contributions of cash and ordinary income property to public charities. If the percentage limitation is exceeded, the excess generally can be carried forward five years.

On the other hand, taxpayers are only permitted a deduction of 30 percent of their contribution base for gifts of long-term capital gain property to public charities, unless they reduce the value of the property to their basis in the property contributed. In that event, the applicable percentage limitation is increased to 50 percent.

Gifts of long-term capital gain property to private foundations are further limited, in that the percentage limitation is 20 percent of the donor's contribution base. Moreover, in computing the value of the donated property, the taxpayer must reduce the deduction by the property's built-in capital gain. A limited exception is available under the Code for contributions to private foundations of so-called "qualified appreciated stock," which is, in short, publicly traded stock.

Subject to these limitations, the taxpayer may use the fair market value of such property in determining the amount of the deduction, regardless of the taxpayer's basis in the property.

The loss of the step up in basis may further aggravate the decline in charitable contributions caused by the repeal of the estate tax. Taxpayers holding low carryover basis property will be less likely to contribute such property to charity because of the reduced charitable contribution deduction. If the contribution is to a private foundation, the donor will be subject to a percentage limitation based on his or her basis in the property.

A smaller charitable contribution deduction will also result in less contributions to public charities because donors are likely to be forced to elect the 30 percent limitation (which is determined based on the property's fair market value), rather than the higher 50 percent limitation (based on the property's basis, which may be lower). Otherwise, the taxpayer would have to sell the property, recognize the capital gain and then contribute the proceeds in order to enjoy the full value of the charitable contribution deduction.

A carryover basis system will also put additional planning burdens on taxpayers, executors and trustees to reallocate gifts and bequests so that low-basis assets are transferred to charitable beneficiaries and high-basis assets to family members. This reallocation will become necessary to encourage subsequent gifts and to reduce the built-in income tax liability. To the extent such a reallocation is effective, it will reduce the utility of the carryover basis as a revenue offset for the repealed Federal estate and gift tax.

D. International Games.

Expatriation. The repeal of the estate tax presents new planning opportunities and incentives for persons who are neither U.S. citizens nor U.S. residents (that is, "non-resident aliens"). Because such persons generally are exempt from Federal capital gains taxes, implementing a carryover basis system to replace the repealed estate tax may lose its intended effect.

Whereas the Federal income tax applies to a U.S. citizen's or resident's worldwide income, non-resident aliens generally are subject to U.S. income tax only on their U.S. sourced income. For non-resident aliens engaged in a U.S. trade or business, any income effectively connected with the conduct of that business is taxed in the same manner as a U.S. citizen. Investment income, on the other hand, is taxed at a flat 30 percent rate, subject to certain exceptions (and subject to any lower treaty rates).

Non-resident aliens who are not engaged in a U.S. trade or business are not subject to tax on capital gains, whether or not the gains are U.S. sourced, unless the gains relate to the sale of a U.S. real property interest. Thus, sales of appreciated stock or other non-real property assets, if made by a non-resident alien who is not engaged in a U.S. trade or business and who has no connection to the U.S. other than the fact that he or she holds such stock or property, generally are not taxed.

If the estate tax is repealed, property transferred to a non-resident alien will forever escape taxation. This presents a significant planning opportunity for U.S. persons who anticipate a significant inheritance. Such persons could decide to expatriate before receiving the inheritance. If the estate and gift tax is repealed, appreciated property could then be transferred tax-free to such persons, who could then sell the appreciated property without incurring any Federal income tax.

Congress did enact provisions that continue to tax tax-motivated expatriates for ten years on certain U.S. sourced income as though they remained U.S. citizens or residents. However, in order for this ten-year "look back" to apply, there must be evidence that the expatriation was tax motivated. A former U.S. citizen or resident is presumed to have expatriated with a principal purpose to avoid U.S. taxes if the individual's average annual income tax liability (the "tax liability test") or the individual's net worth (the "net worth test") on the date of expatriation exceeds certain thresholds. The thresholds are indexed for inflation. The tax liability and net worth test thresholds for 2001 are approximately $115,000 and $580,000, respectively.

However, if the U.S. citizen or resident expatriated before receiving the inheritance, and therefore before exceeding the statutory thresholds, tax-motivated expatriation would certainly be more difficult to establish. As a result, the U.S. citizen or resident could expatriate before receiving the inheritance without being subject to the ten-year "look back" rule.

Non-citizen spouses. Similar planning opportunities are available for transfers to non-citizen spouses. Generally, a donor who is a U.S. citizen is allowed an unlimited marital deduction for gifts and bequests to the donor's spouse. This "deduction" is, in fact, only a "deferral" because the transferred property is includable in the recipient spouse's estate at death (unless the property is consumed or given away during the surviving spouse's lifetime). Thus, the assumption that the property transferred by the first spouse tax free to the surviving spouse would eventually be subject to transfer tax justified the unlimited marital deduction. However, where the donee spouse is not a U.S. citizen, it is possible that the transferred property would escape taxation because of the limited application of the tax rules to non-resident aliens. Thus, the same property might escape taxation entirely because of the combination of both the unlimited marital deduction and the limited reach of the Federal estate and gift tax rules to non-resident aliens.

To prevent this result, Congress enacted a statutory provision that denies the Federal estate tax marital deduction for bequests to non-citizen spouses unless the property passes to the spouse through (or is placed by that spouse in) a "qualified domestic trust" ("QDOT"). Once the property is placed in the QDOT, a transfer tax is imposed whenever property (other than income) is distributed from the trust (with certain exceptions for "hardship" distributions). Thus, the QDOT serves as an "escrow arrangement," ensuring that if property is distributed to the spouse (and therefore moves beyond the reach of the transfer tax system), the appropriate amount of transfer tax will be collected.

If the Federal estate and gift tax regime is repealed and transfers can be made tax free, the non-citizen spouse can, subject to the expatriation rules noted above, move abroad and later sell the property without incurring any U.S. tax. Thus, the expectation that a carryover basis system will recapture a substantial portion of the revenue lost by the repeal of the Federal estate and gift tax regime will not be realized.

IV. IMPACT ON STATES

A. Cost of Elimination of Estate Tax; Alternatives.

Under the present structure, 41 states and the District of Columbia have an estate tax, and the other 9 states have inheritance, succession or other taxes in lieu thereof.

It has been estimated that state tax revenues from all sources average about $1 trillion per year. With the estate tax raising about $5 billion annually in state tax revenues, the states would lose about 1/2 percent of their revenues if the estate tax were repealed. Although this represents only 1/2 percent of total tax revenues, think of the raw cost to the states of losing $5 billion of revenue.

Where would the states replace such revenue? Through increased income taxes, sales and use taxes, intangible taxes, tangible personal property taxes and/or user fees? In any such case, the real cost is imposed on a broader spectrum of persons, the overwhelming majority of which are persons with lower incomes and much smaller asset bases, who are most likely to feel the pain of non-progressive taxes, rather than those who benefit from the repeal of the estate tax.

B. Changes in Domicile or Trust Situs.

Today, many individuals change domicile to eliminate or substantially reduce state income taxes. However, there is generally no focus on changing such domicile from one state to another to escape state estate taxes, inasmuch as, with a few notable exceptions, the state estate tax is generally absorbed into the Federal estate tax.

The repeal of the Federal estate tax in favor of a carryover basis system will increase the pressure on individuals to relocate to jurisdictions without an estate tax, resulting in a loss of revenue for states that fail to adapt.

Likewise, there would be a major migration of trusts, both new and (to the extent feasible) existing, into states without a state income tax, irrespective of where the settlors or beneficiaries reside.

V. CONCLUSION

In light of a deep-seated desire on the part of all sides of the debate to achieve fairness and equity for all, while effectively eliminating the Federal estate and gift tax for about 99 percent of the American population, the following seven-point plan is proffered:

1. Increase the per-taxpayer amount not subject to Federal estate or gift tax immediately to $5,000,000.
    a. Do so in 1 step, without any phase-in.
    b. On January 1 of each year, increase such amount by 5 percent, on a compounded basis.
    c. Eliminate the qualified family-owned business interest deduction (Code Section 2057).
2. Make such $5,000,000 a true exemption from Federal estate and gift tax.
    a. The 18 percent rate would begin to apply at $5,000,001 in the first year, at $5,250,001 in the second year, and so forth.
    b. Move the top rate bracket down to 40 percent.
3. Retain full step-up of basis on death and permit step-up of basis on gifts, other than those subject to the annual exclusion or otherwise not deemed gifts.
    a. This would encourage unlocking assets prior to death.
    b. Recipients might be more likely to dispose of assets than the transferors.
4. Increase the annual gift tax exclusion per donee immediately to $30,000.
    a. Do so in 1 step, without any phase-in.
    b. On January 1 of each year increase such amount by 5 percent, on a compounded basis.
    c. Apply the exclusion to all gifts, whether present or future interests.
5. Equalize residents of non-community property states with those of community property states.
    a. Provide stepped-up basis on death for all property held with a spouse as tenants by the entirety or joint tenants with rights of survivorship.
    b. In order to do so, the Federal estate and gift tax law will need to supersede the state common or civil law, but only for Federal tax basis purposes.
6. Expand the availability of Code Section 6166—currently providing for a deferral of Federal estate taxes at a favorable interest rate, but only for a qualifying "interest in a closely held business"—to all estates.
    a. This will put all taxpayers on the same level playing field.
    b. Currently, older taxpayers, who move to an inactive status in connection with such assets as rental real estate, are severely disadvantaged.
7. Eliminate (and bury forever without ceremony) the generation-skipping transfer tax.
    a. The GST tax complexity far outweighs any usefulness.
    b. Too much time and energy is provided, and too many incomprehensible clauses in Wills and trust agreements, are drafted in order to avoid, defeat or outsmart the GST tax.
    c. While its actual applicability is very limited, its potential reach and cause for angst are unlimited.

Thank you again for the opportunity to testify at this historic hearing. I can only wish you, and, through you, your multifarious constituents, the very best of success in the outcome of your endeavors.

COMMUNICATIONS

AMERICAN COUNCIL FOR CAPITAL FORMATION
CENTER FOR POLICY RESEARCH

SPECIAL REPORT

March 2001

Macroeconomic and Revenue Effects of the Elimination of the Estate Tax

For nearly a quarter of a century, the ACCF Center for Policy Research has sponsored pathbreaking research on tax policies to encourage saving, investment, and economic growth. As the Bush Administration and the U.S. Congress prepare to debate various tax reduction proposals, the Center, in order to focus the discussion on the macroeconomic impact of five different options for repealing or reforming the federal estate tax, offers this Special Report, based on macroeconomic estimates, ***prepared by Dr. Allen Sinai, chief global economist and president, Decision Economics, Inc.***

The key conclusions of Dr. Sinai's preliminary findings are that when his model of the U.S. economy is used, estate tax repeal or reform increases both real Gross Domestic Product (GDP) and U.S. employment, compared to the baseline forecast. In addition, there are more new business incorporations and greater potential output of goods and services. Finally, federal tax receipts rise in response to the stronger economy, feeding back approximately $0.20 per dollar of estate tax reduction, to some extent helping to pay for the estate tax reduction. In fact, one of the options, immediate repeal and elimination of step-up in basis, could increase total federal net tax revenues by $55 billion over the 2001–2008 period due primarily to the repeal of step-up in basis.

INTRODUCTION

The Sinai-Boston Econometric Model of the U.S. is a large-scale quarterly econometric model that includes considerable detail on aggregate demand, financial markets, sectoral flows of funds and balance sheets, interactions of the financial system with the real economy, and detailed trade and international financial flows. The advantage of a general equilibrium macroeconomic model instead of a partial equilibrium model for analyzing the impact of a change in the tax code is that a general model measures how the economy will respond after all aspects of the economy, financial system, inflation, and potential output are allowed to adjust to the new tax rates.

MACROECONOMIC IMPACTS

Dr. Sinai estimates the impact of five different reform and repeal options, including: 1) immediate repeal coupled with elimination of the step-up in basis; 2) immediate repeal of the estate tax with step-up in basis retained; 3) phaseout of the estate tax over eight years; 4) reduction of the top estate tax rate from 55 percent to 20 percent (the highest capital gains tax rate); and 5) reduction in the top estate tax rate from 55 percent to 39.6 percent (the top current individual income tax rate). Option 3 passed Congress last year as H.R. 8, the "Death Tax Elimination Act of 2000."

Preliminary results from early simulations, subject to further work and analyses, suggest the following effects from immediate elimination or reform of the estate tax, retroactive to January 1, 2001.

- GDP increases a cumulative $90 billion to $150 billion over the 2001–2008 period, or 0.1 percent to 0.2 percent compared with the baseline for several years out of the eight years in the preliminary runs (see Figure 1 and Table 1).

- Job growth ranges from 80,000 to 165,000 per year and the unemployment rate is slightly lower as a result (by 0.1 percent), with essentially no change in the inflation rate (see Figure 2 and Table 1).

The ACCF Center for Policy Research is the education and research affiliate of the American Council for Capital Formation. Its mandate is to enhance the public's understanding of the need to promote economic growth through sound tax, trade, and environmental policies. For further information, contact the ACCF Center for Policy Research, 1750 K Street, N.W., Suite 400, Washington, D.C. 20006-2302; telephone: 202/293-5811; fax: 202/785-8165; e-mail: info@accf.org; Web site: www.accf.org.

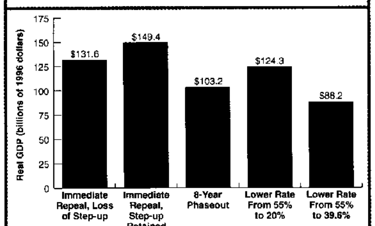
Table 1 Impact of Estate Tax Repeal/Reform on U.S. Economic Growth, 2001–2008
Changes from baseline, cumulative except as otherwise noted

	Immediate Repeal, Loss of Step-up	Immediate Repeal, Step-up Retained	8-Year Phaseout	Lower Top Rate From 55% to 20%	Lower Top Rate From 55% to 39.6%
Real GDP (billions of 1996 dollars)	$131.6	$149.4	$103.2	$124.3	$88.2
Employment (average difference in levels per year)	164,761	132,443	94,311	113,647	80,521
New Business Incorporations (average difference in levels per year)	45,736	261,181	130,859	188,929	145,427
Total Federal Tax Receipts (fiscal years)	$54.3	$-211.1	$-110.4	$-108.8	$-37.0

Note: Assumes the saving in taxes paid is treated as an increase in disposable income as opposed to reinvesting in assets or paying down debt. Under different assumptions about how the tax savings is taken, the quantitative .estimates might change but the direction of the results would not.

Source: "Macroeconomic Effects of the Elimination of the Estate Tax," by Allen Sinai, chief global economist and president, Decision Economics, Inc., preliminary report prepared for the American Council for Capital Formation Center for Policy Research, Washington, D.C., March, 2001.

Figure 1 Real GDP Growth and Estate Tax Repeal/Reform, 2001–2008
Cumulative change from baseline in billions of 1996 dollars



- Both consumption and personal saving rise, as does national saving, despite the loss in estate tax receipts to the federal government.
- The level of potential output is somewhat higher, by an average $6 billion to $9 billion per year.
- Tax receipts, excluding estate tax receipts, rise in response to the stronger economy and financial system, feeding back approximately $0.20 per dollar of estate tax reduction, to some extent helping to pay for the estate tax reduction. One *option—immediate repeal combined with the elimination of step-up in basis—increases total federal tax receipts by almost $55 billion over the 2001–2008 period compared to the baseline forecast because of the tax saving from elimination of step-up and the increase in capital gains realizations* (see Figure 3 and Table 1).

Dr. Sinai estimates that about $45 billion of the $55 billion revenue increase is due to the elimination of step-up, rather than to faster economic growth.

Phasing in estate tax relief over eight or 10 years obviously reduces the macroeconomic impacts as does eliminating step-up in basis.

Conclusions

While work remains to be done in simulating and estimating the effects of removing the estate tax, this early work provides a glimpse of the directions of movement for key parameters of the macroeconomy—economic growth, jobs, entrepreneurship, and potential output—in response to estate tax elimination. Dr. Sinai's findings about the positive economic impact of estate tax repeal buttress the results of a recently released ACCF Center for Policy Research analysis by Syracuse University Professor Douglas Holtz-Eakin, "Estate Taxes, Labor Supply, and Economic Efficiency." ❖

Figure 2 U.S. Employment and Estate Tax Repeal/Reform, 2001–2008
Annual average change compared to baseline

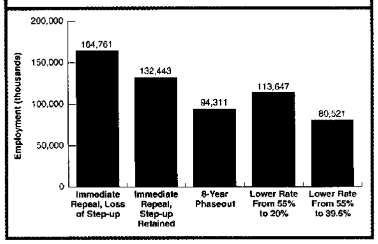
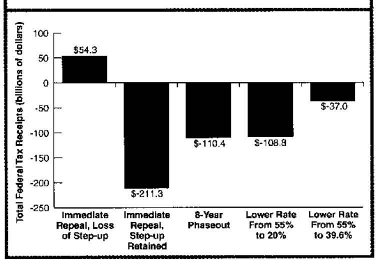


Figure 3 Total Federal Tax Receipts and Estate Tax Repeal/Reform, 2001–2008
Cumulative change from baseline, fiscal year basis, in billions of dollars



Statement of the National Automobile Dealers Association

[SUBMITTED BY ROBERT J. MAGUIRE]

Mr. Chairman and members of the Subcommittee on Taxation and IRS Oversight, I am Robert J. Maguire, CEO of Saturn of Bordentown, Saturn of Toms River, Bob Maguire Chevrolet Inc., Bordentown, N.J., Windsor Nissan, Highstown, N.J., and 2001 chairman of the National Automobile Dealers Association. On behalf of NADA, I commend you for holding this hearing and am pleased to submit this testimony in favor of eliminating the federal estate tax.

NADA represents more than 19,500 franchised new car and truck dealers who employ more than one million people nationwide. The majority of NADA's members are small family-owned and community-based businesses. Many dealerships span two, three or four generations. I am a second-generation dealer myself. My father started his business in 1938, and I joined him in 1962 before beginning my own in 1976.

The estate tax in its current form is destructive to America's entrepreneurs. Under the current law, heirs could be required to pay up to a 55 percent tax on the estate when the owner dies. There is something very wrong in our system when a small businessman or businesswoman spends a lifetime building a company, paying taxes, providing jobs and serving the community only to have the government step in and take 55 percent of everything at death.

The death of the owner of a small business can trigger an estate tax obligation that has immediate adverse consequences. The surviving family members often do not have sufficient cash reserves to cover the estate tax bill, so they have to borrow money to pay the IRS. This increased debt severely restricts the ability of the surviving entity to obtain additional capital, which can cripple or kill the business.

Even the most sophisticated estate tax planning and the purchase of life insurance cannot mitigate the effects of the death tax. Most assets of automobile dealers are not liquid. A dealer's capital is invested in the land under the dealership, buildings housing showrooms, vehicle repair equipment, and other facilities. Also, dealers need substantial working capital to finance new and used car inventory, as well as parts and accessories. If the government demands half of the fair market value of the business just because the owner dies, families in the automobile business are left with few options but to sell their businesses or incur substantial debt to pay the tax.

The estate tax also negatively impacts businesses before the death of an owner. Dealers spend thousands of dollars each year in fees to attorneys, accountants and life insurers in an attempt to prepare for an eventual estate tax liability. Dealers resent paying taxes on already taxed assets, and are frustrated by throwing money at preparation costs rather than on more productive measures such as business expansion and employee benefits.

Moreover, the notion that death taxes affect only the rich is wrong. To the extent that these taxes reduce savings and investment, they slow economic growth and job creation. When a family-owned business has to curtail growth or, in many cases, liquidate part or all of the business to pay estate taxes, it hurts everyone involved—owners, customers, suppliers, employees, and their families.

Preserving family-owned and community-based businesses is crucial to the health of the national economy and essential to the economic welfare of local communities. These businesses provide the majority of new job growth in the country. Very often, family-owned businesses are central to the economic vitality of local communities, providing career opportunities for millions of working Americans. The vast majority of the one million people that dealers employ depend on the stability of our businesses to provide for their families. The elimination of the estate tax will enable dealers to continue to provide these jobs and will help assure the continuity of family business ownership for generations to come.

The death tax is anything but fair. I urge Congress to bury the death tax for good.

LAW OFFICES OF MARTIN J. OPPENHEIMER,
NEW YORK, NEW YORK, *March 29, 2001.*

EDITORIAL SECTION,
Subcommittee on Taxation,
Senate Finance Committee,
Dirkson Senate Office Building, Washington, DC

Re: A Third Dimension for Estate and Gift Tax Reform

Gentlemen: This letter is submitted in connection with your Subcommittee's recent hearing addressed to proposals relating to estate and gift tax reform, with the request that it be included in the record.

The proposals come in a variety of shapes and sizes. That of the President, seconded in bills introduced by several members of the Senate, would eliminate the taxes altogether. Other members would leave the taxes in place but increase the amounts of the lifetime unified credit and the deduction for qualified small businesses (effectively tax exemptions). The Democratic alternative to the bill vetoed by President Clinton, while also increasing the exemption amounts, would have provided an across-the-board reduction in the rates at which the taxes are imposed.

My letter is directed to extending the reform proposals, short of repeal, that are on the table. These have in common the vital objective of making our system of wealth transfer taxation a fairer one than it is today. Increased exemptions, by raising the level at which taxation will begin, and rate reductions to diminish the severity of the tax upon those transfers still in excess of the new thresholds obviously would be major steps in this direction.

Nevertheless, by focusing upon exemption amounts and rates, those measures fail to address a possibly more fundamental shortcoming of the system, which arises from its delineation of the transfers upon which the tax is imposed. Following enactment in 1916 and 1924 of the precursors to the current estate and gift taxes, virtually all transfers between individuals above the annual gift tax exclusion and specific exemption amounts were subject to tax. This even-handed treatment, however, began to erode with the passage in 1948 of a 50% marital deduction and disappeared in 1981 when the marital deduction was increased to 100%. As a result, most inter-spousal transfers have been removed from the taxman's reach. (For a summary of the legislative history see Report of the Staff of the Joint Committee on Taxation to your Subcommittee, *Description and Analysis of Present Law and Proposals Relating to Federal Estate and Gift Taxation* (3/14/01), Part I–B.)

A wealth transfer tax that applies to gifts and bequests to other individual recipients but carves out an exception for like transfers between husband and wife can hardly be said to meet the test of fairness. No good reason is apparent why, so as to conform to that standard, the exception should not be extended to gifts and bequests from children to parents, to transfers between brothers and sisters and to transfers between unrelated persons of the same generation.

Your Subcommittee therefore may wise to consider—as a third measure of reform and tax reduction—legislation to reconstitute the marital deduction into a broad-based exemption applicable to all gifts and bequests made to a member of the same or higher generation to that of the transferor.* It can be anticipated that although the exemption would cover the entire spectrum of lateral transfers, unmarried couples, particularly those with relationships of long standing, would probably be its main beneficiaries.

In so narrowing the range of taxable transfers, the legislation would strengthen the basic structure of the transfer tax system, which as exemplified by its generation-skipping tax component is mainly directed to taxing the passage of wealth *from one generation to the next*. Moreover, in contrast to the breadth of the proposals increasing the unified credit amount, which would apply to all transfers that are presently taxable, the new benefit would apply only to a minor portion of those gifts and bequests that are now taxable. For this reason and because that benefit usually would be available only once (since in most instances the recipient probably would not later transfer what he had received to other persons to whom the exemption had been the resulting revenue loss predictably would be relatively small.

Respectfully submitted,

MARTIN J. OPPENHEIMER.

STATEMENT OF THE SENIORS COALITION

[SUBMITTED BY JOHN V. WESTBERG]

Chairman Nickels, Ranking Minority Member Conrad, and Members of the Subcommittee, my name is John Westberg, and I am chairman and chief executive officer of a family-owned and -operated manufacturing company in Illinois that my father started in the basement of our home 44 years ago. Our company has achieved remarkable growth and success since then. We have built our business through risk-taking, hard work, excellent customer service, and good old-fashioned Midwestern values and ethics. From one man's dream has grown a thriving company that today

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* The "same generation", in the case of unrelated parties, could be defined as individuals no more than, say, 20 years apart in age. Also, the exemption presumably would be subject to an anti-abuse rule. Under this rule, as under the present marital deduction, gifts and bequests to persons who were not U.S. citizens would qualify for exemption only if steps were taken to assure that tax would be collected on a subsequent transfer by the recipient should that person move abroad. The anti-abuse rule also would prevent use of an intermediary to obtain an exemption that otherwise would not be available, as for example where a father made a gift to an unrelated party who was deemed to be in the same generation as both the father and the daughter (*i.e.*, someone no more than 20 years younger than the father and no more than 20 years older than the daughter) and that person in turn made a corresponding gift to the daughter.

employs more than 500 workers at plants in Illinois and the West and is an internationally recognized industry leader.

I appreciate very much the opportunity to present my views and those of The Seniors Coalition (TSC) of which I am a member. My objective is to offer both the small business and senior perspective on the compelling need to abolish unfair and pernicious death taxes and protect and preserve family-owned businesses.

The Seniors Coalition is a leading non-profit, non-partisan national education and advocacy organization representing nearly four million seniors and their families. Its mission is to promote and protect the health, financial well being, freedom, and quality of life of America's seniors. TSC is committed to free-market principles and the policies of limited government, reduced regulation, and lower taxes and spending. These principles and policies are essential to the creation and growth of a robust economy that provides opportunity, jobs, and prosperity for all Americans. Moreover, they help guarantee the freedom and financial independence seniors need to lead healthy, productive, and fulfilling lives.

I commend you, Mr. Chairman, for your leadership in convening this hearing to examine the significant financial burdens estate taxes impose on the heirs of family business owners, as well as the threat they pose to the survival of family-owned firms and the employment security of their workers.

DEATH TAXES—THE POWER TO DESTROY AMERICA'S LEGACY OF FAMILY-OWNED BUSINESSES

"The power to tax is the power to destroy"—Sam Adams

Estate taxes, ranging from 37 percent to 55 percent, are significantly higher than other tax rates. For example, the lowest estate tax rate of 37 percent is nearly as high as the highest income tax rate of 39.6 percent. Federal death taxes erode the value of the assets and investments family-owned business owners have worked hard to build and grow. In family-owned companies, the key point to remember is that the business is the primary investment and asset.

The death tax is grossly unfair since the revenue it generates from earnings and assets has been taxed at least once and, in some cases, two or three times, through income, Social Security, and other taxes. Because the death tax can confiscate more than half the value of a family's investment in a business, it punishes saving and investment, acts as a disincentive to work, and discourages business creation.

The impact of the estate tax on small firms, family-owned businesses, and farms can be devastating. The value of a business is included in a deceased owner's estate and taxed at a rate as high as 55 percent. As a result, this tax can destroy businesses by forcing heirs to sell the business or farm, buildings, land, or equipment to pay the tax bill and lawyers.

According to the Center for the Study of Taxation, seven of 10 family businesses do not survive through the second generation. Nearly nine in 10 of these firms do not make it through the third generation. The federal estate tax contributes to the failure of these businesses. According to a survey by Prince & Associates, nine in 10 successors whose family-owned businesses failed within three years of the principal owner's death said trouble paying estate taxes contributed to the company's demise. The loss of these businesses means decreased economic growth, fewer jobs, and lower tax revenues.

Estate taxes also reduce the stock of capital in the economy overall. During the last century, according to a December 1998 Joint Economic Committee (JEC) report, the death tax removed $949 billion out of the stock of capital.

The death tax is also inefficient. It accounts for only one percent of total federal revenues. Yet, according to the JEC report, the levy costs the government and taxpayers nearly the same amount for enforcement and compliance as it generates in revenue. For every $1 in revenue it brings in, the federal government spends 65 cents in enforcement costs.

The death tax deprives parents—seniors and, in many cases, family business owners—of the opportunity to pass on the full value of the assets they have accumulated during a lifetime of work. It robs widows and widowers and children alike of an inheritance that would be worth more if not for confiscatory death taxes.

A PERSONAL PERSPECTIVE ON THE DEATH TAX: IMPLICATIONS AND CONSEQUENCES FOR HEIRS OF A FAMILY-OWNED BUSINESS AND THEIR EMPLOYEES

My family and I own and operate a manufacturing business that has grown in 44 years from a one-man startup venture to a company with over 500 employees today. We employ engineers, tool and mold makers, and electronic assembly workers. The revenue our company generates and attracts to our community is critical to its economic health and survival. Our company's founder—my father—is now very advanced in age, so it is likely that the death tax will impact our company in the near future.

Our firm is representative of 21,163 privately held manufacturing companies in Illinois alone. According to the Illinois Manufacturers Association, these privately held manufacturers employ 793,238 workers, accounting for about 66 percent of all manufacturing jobs in the state. The wages these manufacturers pay their workers are essential to the health and economic survival of the state and local economies. Most, if not all, of these manufacturers will face the same death tax survival issue that our company will confront. This is because closely held companies must pay death taxes. In contrast, publicly held companies—corporate giants like GM, Ford, Microsoft, and others—are unaffected by these taxes since they are not subject to them.

When the death tax hits the owners of Illinois's privately held manufacturing companies, it could place 793,238 workers' jobs in jeopardy. The reasons for this are clear. Their employers may send their manufacturing jobs overseas in order to earn the extra profit needed to pay the death tax. Naturally, the federal government will then lose all those payroll taxes over all the future years. This tax revenue loss will far exceed any death tax revenues collected once per generation.

A second option would be for employers to try to keep jobs here in the United States; however, as they struggle to pay the death tax, their companies will become financially weakened, resulting very likely in downsizing, job loss, and the eventual sending of remaining jobs overseas in order to survive.

Manufacturing companies, including our own, are important economic contributors. For example, our payroll totals over $11 million annually. There is more to this figure, though, than meets the eye. A University of Illinois study found that each dollar of manufacturing wages becomes $3.30 of retail and service wages before being sent out of the community to buy more merchandise. This means that $11 million in wages produced by our company turns into more than $36 million in wages for our local economy. The multiplier effect of our payroll alone supports local businesses and jobs, contributing to our economy and the prosperity of our community.

The federal government also benefits from this generation of income in other substantial ways. It collects additional revenue from payroll and other taxes. Our company and employees alone pay more than $2.6 million (24 percent of $11 million) in payroll taxes annually. Moreover, if you take into account the cumulative wage effects of our payroll, an additional $8.6 million in payroll taxes is generated for the government.

Upon the death of our company owners, the federal government will tax our firm ostensibly to ensure a steady source of revenue and to prevent wealth from remaining in the hands of the rich. The problem with this thinking is that the death tax will give the federal government a one-time windfall when it is applied, but that one-time windfall will come in lieu of succeeding generations of federal payroll, income, and other taxes.

Our company may be worth approximately $18 million. If my father and mother were to pass away today—they are 91 and 88 years old respectively—their 25 percent ownership interest in the company—estimated at $4.5 million—would be subject to the death tax. This levy would take 55 percent of the $4.5 million, which amounts to about $2.5 million. We have already used most of the two $675,000 exemptions.

A death tax burden of that size is very problematic for our company. In our business, profit margins are very small. To stay in business, we would very likely be forced to send about 500 jobs abroad where labor is cheaper and because we would need higher profits to pay the death tax. Therefore, the federal government would sacrifice the payroll taxes of the 500 plus jobs we would send overseas, in addition to fruits of the wage effect on our community's economy.

I would like to draw attention to a poignant irony here. By subjecting a business like ours to the death tax, the federal government will get a one-time windfall of $2.5 million. The government's insistence on retaining the death tax to avoid losing revenue will in the end cost it 25 to 30 times that in lost future payroll taxes. Our death tax bill will be about the same amount that we pay in payroll taxes each year. Therefore, in the process of collecting about $2.5 million in death tax revenue from our corporation once every generation, the federal government will have to surrender 25 years of $2.6 million in annual payroll tax revenues, or about $65 million. But it also will lose 500 or more jobs; destroy the output our company contributes to the local economy; eliminate years of future payroll and other taxes; and fail to prevent wealth from staying in the hands of the so-called rich.

The U.S. Small Business Administration estimates that 25.5 million small businesses in America like ours employ more than half the country's private work force, create three of every four new jobs, and generate a majority of American innovations. The federal estate tax poses a continued threat to the economic growth and prosperity these small firms provide for the nation. In fact, according to the JEC study cited earlier, the federal estate tax is a leading cause of the dissolution and destruction of thousands of family-owned and -operated businesses.

The death tax is not only a tax on business. It is a heavy tax on risk-taking, investment, business formation, employment, and new job creation. Obviously, this levy is counterproductive in several ways. Not only does it hurt government revenues, it hurts economic growth. Unless this unfair tax is repealed, millions of men and women who work at privately held manufacturing companies will watch helplessly as jobs and livelihoods are lost and the business owners become richer due to their new low-waged foreign workers. Then the federal government can dream about what it could have done with all those payroll taxes that are now being paid by the overseas manufacturers to their government.

Thank you for the opportunity to provide these comments. The Seniors Coalition and I stand ready to assist you and this Congress in abolishing the death tax and protecting and preserving family-owned businesses.

STATEMENT OF FORMER SENATOR ALAN K. SIMPSON (R–WY)

Senator Nickles, Senator Conrad, and all the other distinguished Members of the Senate Finance Subcommittee on Taxation and IRS Oversight. I am very pleased to have this opportunity to submit testimony today on the issue of the federal estate tax. I shuddered to be present personally for fear you would "pick on" your old Finance Committee colleague!

First let me express my strong support for the President's efforts to substantially reduce taxes for all Americans. President Bush, Vice-President Cheney, and the entire Administration have successfully and commendably changed the course of the debate in this country from whether we should cut taxes to how we should best do it. This is the most talented group of men and women to serve in the highest levels of an Administration in my lifetime. They are also extremely savvy and fully understand the legislative process. Lawrence Lindsey, the President's chief economic advisor, recently discussed the tax package with the Republican leadership saying: "You guys make the sausage, I just brought the meat and spice." To me, this indicates that the President, the Vice-President, and other key officials who crafted the Administration's plan would not summarily reject constructive dialogue on how best to achieve their legislative goals. Even from my perch here in the private sector, I too would like to engage in such a dialogue. However, at the end of the day, when the discussions and the debate are over, this country deserves the strongest possible bipartisan tax reduction plan, and I for one fully intend to be a very vocal supporter of that package.

In the spirit of early, constructive dialogue I would also respectfully recommend to this Subcommittee and to my friends in the White House, that as an alternative to a phase out of the estate tax over an 8 to 10 year period, they might take a serious look at providing immediate and dramatic estate tax relief by greatly increasing the threshhold over which an estate would be liable thereby immediately eliminating nearly 90% of those estates that, under current law, would have to pay an estate tax. For the small number of estates left that would still have to pay, I would further recommend a reduction in the rates. I am not attempting to advise you what the threshhold should be, but it should be large enough to protect the family ranchers and farmers that I have known from ever having to worry about this liability. In fact, to ensure that result, due to their unique status I think it would be worthwhile to craft a special exemption from estate taxes for family ranches and farms. There are several reasons why I believe that this method of reform is the best route to take, and I will briefly list them in this testimony.

I support the efforts of Americans for Sensible Estate Tax Solutions coalition (ASsETS) which does in fact have members who do have an economic interest in this matter. There is nothing wrong with that, but my participation in this effort is primarily motivated by what I believe a phased-out repeal of the tax would do to charitable giving in this country. My wife, Ann, and I have spent a substantial part of our lives serving on the boards of institutions such as Fords' Theater, the Folger Shakespeare Library, the Buffalo Bill Historical Center, the Kennedy Center, the Terra Museum, the University of Wyoming Art Museum, and the Smithsonian Institution. I have seen first hand how the estate tax promotes charitable giving. In fact the U.S. Treasury has estimated that a total repeal of the estate tax would result is a decrease of up to $6 billion annually in charitable giving. Charles Collier, Senior Philanthropic Advisor at Harvard University, has said that "wealthy donors will clearly leave more money to their heirs than they will to charities if this repeal goes through.” Multibillionaire, George Soros calls the estate tax “one of the main incentives for charitable giving.” From a practical perspective, it’s easy to see that without any estate tax, even on the very wealthiest, potential heirs may likely say: “Dad, don’t leave the Picasso to some museum. Sell it or give it to me, instead.” And it’s not just the Picasso, it’s also real money to universities, hospitals, and other non-profit health and educational groups throughout the country.

My second concern is that there is a great benefit in being able to obtain tax advice which has certainty. The phase out of the estate tax depends too much on what a future Congress may or may not do. This proposed phase-out is really an expression of intent to phase it out over an 8 to 10 year period. In order to reduce the price tag on the so-called total repeal, Americans will have to wait until 2010 for the promise to become a reality. To enact legislation on the assumption that an “estate tax repeal” won’t be modified or reinstated by a future Congress simply assumes too much. Now as I don my Republican hat, I would like the members of this distinguished panel, particularly the current majority to assume the possibility—however frightening you think it may be!—that (1) the control of Congress shifts and (2) a future Congress may need additional revenues in order to fund some disaster relief.

Knowing what we all know about politics, one of the most likely, logical revenue raisers would be to further delay or even cancel the phase-out. So if we are to leave the final decision to future Congresses, the estate planner cannot render the kind of tax advice that Americans deserve. Death is quite bad enough. It’s even worse in combination with financial uncertainty!

The ASsETS Coalition is promoting immediate, drastic reform of the estate tax. We leave it to Congress to decide the threshhold, but consider this: In 1998 the last year for which we have national records, less than 48,000 estates paid any estate tax. That represents 2% of the number of deaths that year. If you set the threshhold at $2.5 million rather than the current law, you would have eliminated nearly 40,000 of those estate taxpayers. If you set the threshhold at $5 million, you would have knocked out nearly 4,700 more estates. That would leave about 3,000 estates in the entire country owing any estate tax at all for that year. Using these 1998 numbers for my state of Wyoming, of 4,000 deaths in 1998, a $2.5 million exemption would have eliminated all but 6 estates. A $5 million exemption would have eliminated all but 2 estates.

Contrary to some of the hot and heavy rhetoric out there, I am not an advocate for the estate tax. It is burdensome, unfair, and ought to be changed. I specifically do not want the estate tax to be a threat to Wyoming’s, or to the rest of the country’s family farmers or ranchers and their ability to pass those properties down to the next generation. In fact, I would even favor a form of legislative “carve out” to ensure their protection. As stated, it is not a question of whether to change the estate tax, but how. I prefer a dramatic, immediate reform which would exempt 99% of Americans from paying anything at all. I would also prefer immediately lowering the top rates for the eight to ten thousand estates that would still be subject to the tax.

One other aspect of total repeal which should be considered is its impact on hard pressed state budgets. Many states have estate tax revenues which are dependent on the Federal version. The February 20, 2001, Dallas Morning News cited that Texas stands to lose $300 million a year. My state of Wyoming derives $9.7 million in these kind of estate taxes each year. A total repeal would put a hole the size of a .45 caliber slug in my state’s budget!

In summary, I very much want the President to succeed with a $1.6 trillion tax cut. According to the February 18 Washington Post, Lawrence Lindsay stated that the President wants to see his approach adopted, but is leaving the structure up to the Congress. In order to keep the package at $1.6 trillion, a less costly, long-term phase-out of the estate tax was chosen. My position, respectfully submitted to you, is to keep the package’s total price tag, but to provide dramatic benefits immediately, provide additional protection for family farms and ranches, eliminate all but the super wealthiest from paying any estate tax at all, then reduce the rates for the remaining estates which do have to pay. That’s it. Such an approach will cost less, will maintain incentives for charitable giving, will protect farms and ranches, will protect state revenues, and will provide clarity and certainty in tax planning.

I would earnestly trust that such an approach would merit your full consideration. Thank you so much. My best personal regards to all of you.

STATEMENT OF THE U.S. CHAMBER OF COMMERCE

[SUBMITTED BY MARTIN A. REGALIA, PH.D., VICE PRESIDENT AND CHIEF ECONOMIST]

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the federal estate and gift tax and to indicate its full support for repeal of the tax. The U.S. Chamber is the world's largest business federation, representing more than three million businesses and organizations of every size, sector and region. This breadth of membership places the Chamber in a unique position to speak for the business community.

BACKGROUND OF THE ESTATE AND GIFT TAX

Originally, federal estate taxes were imposed primarily to finance wars or threats of war. The first federal estate tax was a stamp tax imposed in 1797. The first progressive estate tax was adopted in 1916, with the maximum tax rate varying from 10 percent in 1916 to 77 percent in 1941. The gift tax was first imposed in 1924, repealed two years later, and then reinstated in 1932.

Before 1976, estate taxes were imposed on transfers occurring at death, while gift taxes were imposed on transfers made during a taxpayer's life. In 1976, the estate and gift tax structures were combined and a single unified graduated estate and gift tax system was created. This unified tax system has since applied to the cumulative taxable transfers made by a taxpayer during his or her lifetime and at death.

In 1948, Congress provided the first martial deduction, allowing 50 percent of the value of any property transferred to a spouse to be excluded from a decedents taxable estate. This deduction was later increased to 100 percent. In addition, an individual can give to an unlimited number of recipients up to $10,000 each in gifts annually without triggering the gift tax.

Under the current estate and gift tax rate structure, rates begin at 18 percent on the first $10,000 of cumulative transfers and reach 55 percent on transfers that exceed $3 million. In addition, a 5-percent surtax is imposed upon cumulative taxable transfers between $10 million and $17,184,000.

A unified tax credit is available to offset a specific amount of a decedent's federal estate and gift tax liability. From 1987 through 1997, the unified credit effectively exempted the first $600,000 of cumulative taxable transfers of a decedent from the estate and gift tax. Under the *Taxpayer Relief Act of 19971*, the effective exemption amount was increased to $625,000 for 1998, $650,000 for 1999, $675,000 for 2000 and 2001, $700,000 for 2002 and 2003, $850,000 for 2004, $950,000 for 2005, and $1 million for 2006 and years thereafter. The exemption amount, however, was not indexed for inflation after 2006.

In addition, the *Taxpayer Relief Act of 1997* created a new exemption for "qualified family-owned business interests" beginning in 1998. However, this exemption, plus the amount effectively exempted by the applicable unified credit, can not exceed $1,300,000. Whether a decedent's estate can qualify for the maximum $1,300,000 exemption amount will depend on the blend of personal and qualified business assets in the estate at death.

THE ESTATE AND GIFT TAX IS COMPLEX, UNFAIR AND INEFFICIENT

When the government in a free society uses its power to tax, it has an obligation to do so in the least intrusive manner. Taxes imposed should meet the basic criteria of simplicity, efficiency, neutrality and fairness. The federal estate and gift tax fails to meet any of these requisites.

The estate tax is anything but simple to understand or comply with. It is a multilayered taxing mechanism so complex and convoluted that it has given rise to a cottage industry of estate tax planners, accountants and lawyers. While this may be acceptable to those professionals who make their living from the federal estate and gift tax system, it is not acceptable to the thousands of individuals who are forced to pay billions of dollars each year in estate taxes, planning fees, and compliance costs.

Even the simplest of estates require a certain amount of estate tax planning in order to avoid the pitfalls of this complicated tax system. Estate tax planning often includes the creation of one or more trusts, such as a living trust or "Q-TIP" (qualified terminable interest property) trust, adding even more expense for taxpayers. The estate tax system also contains generation-skipping provisions designed to tax transfers from grandparents to their grandchildren. While the "qualified family-owned business interest" exclusion can reduce estate taxes for some businesses, the provision added complexity to an overly complicated tax system.

The estate and gift tax is also inefficient. Taxes are efficient when they waste few resources in the collection process, impose no unnecessary compliance costs on taxpayers and make a high percentage of the proceeds available for public goods. The estate tax has very high collection and compliance costs, even though its revenues only account for slightly more than 1.5 percent of total federal receipts. Individuals and businesses that do not owe estate tax still spend millions of dollars on estate planning and tax return preparation. For example, in 1998, approximately 47,500 estates were subject to the estate tax, however, almost 98,000 estates had to go through the expense of filing federal estate tax returns.

The other characteristics of an acceptable tax are its neutrality and fairness. While measuring these aspects require a certain amount of subjectivity, the estate tax can not be considered either neutral or fair to individuals or businesses. The highly-progressive nature of this tax severely penalizes those who have saved more, risked more, and worked harder than others.

THE ESTATE AND GIFT TAX THWARTS ECONOMIC GROWTH AND PRODUCTIVITY

Public policies should not only improve our nation's current economic environment, but also ensures our future prosperity. The key to a stronger economic future is simple to define (*i.e.*, a high rate of economic growth), but difficult to achieve. It is strong economic growth that will allow us to maintain our position of world leadership, increase our standard of living, and meet the daunting demographic challenges that will begin to present themselves early in the next century.

But economic growth does not occur by accident. Just as our farmers do not rely on good luck for bountiful harvests, neither can we rely on chance or the momentum of the past to propel us in the future. The seeds of tomorrow's economic success must be planted today, and so, when evaluating economic policies, we must ask how they would cultivate long-term economic growth.

By definition, economic growth is simply the product of growth in the labor force (*i.e.*, the number of hours worked) and growth in productivity (*i.e.*, output per hour). With growth in hours worked largely determined by demographics, sensible economic policy must emphasize strong productivity growth.

Virtually all economists agree that strong productivity growth stems from saving and investing in capital—both human capital (education) and physical capital (plant and equipment). Thus the issue of long-term productivity growth and, in turn, economic growth becomes one of fostering additions to, and improvements in, capital. Consequently, today's economic policies must be targeted toward improving economic growth by fostering saving, investment, and capital formation. Only through such pro-growth policies can we lay the foundation of prosperity and security for our children in the 21st century.

To boost productivity, the federal government must end its misdirection of resources and curb its appetite for spending so that national savings and investment can be increased. This will yield stronger productivity growth, which in turn will propel the economy on a higher growth track. Besides balancing the budget, other policy elements that would aid long-term economic growth include overhauling our regulatory and tort systems, enhancing education and job training programs, reducing the tax burden, and reforming the tax code.

CONCLUSION

The case for complete repeal of the federal estate and gift tax is compelling—the tax penalizes savings, results in direct and substantial harm to family-owned businesses and farms, reduces job creations, is complex, costly and inefficient to comply with (and collect) and does not produce substantial federal revenue. While the *Taxpayer Relief Act of 1997* did provide a very narrow class of family businesses with modest relief from the estate and gift tax, it also added complexity. Moreover, relief is needed for all estates, regardless of size, financial structure or composition of assets, and the best relief from the estate and gift tax overall would be its complete repeal.

Clearly, the estate and gift tax depletes the estates of taxpayers who have saved their entire lives, often forcing successful family businesses to liquidate or take on burdensome debt to pay the tax. Taxpayers should be motivated to make financial decisions for business and investment reasons, and not be punished for individual initiative, hard work, and capital accumulation. The U.S. Chamber therefore believes that the federal estate and gift tax should be completely repealed.

WHITE HOUSE CONFERENCE ON SMALL BUSINESS

TAX ISSUE CHAIRS

March 15, 2001

HON. CHARLES GRASSLEY,
Chairman, Committee on Finance
U.S. Senate, Washington, DC.

Re: Statement for the hearing on the President's Estate Tax Proposals

Dear Chairman Grassley: The undersigned are the elected Regional Taxation Chairs representing the 2000 delegates to the last White House Conference on Small Business. We were delegated the responsibility for advancing implementation of the Conference's recommendations with regard to the tax issues and reporting progress back to the delegates.

The President has proposed a tax relief measure that incorporates full repeal of the estate tax, phased in over a period of years, and making permanent the tax credit for research and experimentation. We are gratified his proposal addresses these elements for tax relief which our Conference recommended to Congress, and which we have personally recommended to your Committee in past testimony.

We have said in the past that the White House Conference endorsed full repeal of the estate tax, but the delegates have been grateful for any changes that reduce the tax heirs to a business might pay at the death of a principal owner in order to preserve what is the single largest source of new job opportunities in America, the small business. The passage of a small business from one generation to the next also has a positive impact on the community, promoting stable employment, long-term community support of community groups, and an active interest in maintaining the quality of education and life in the "neighborhood." Whatever could be done to increase the exclusion or move family-owned business or farm property out from under the estate tax is welcomed.

The President's proposal does not appear to specify how property that passes to heirs is to be treated for tax purposes. The Congress will decide whether the property receives a stepped up basis, or whether the old basis is carried over to the heirs. A number of the members of our White House Conference group are concerned about the complexity and difficulty of keeping adequate records to support a carry-over basis. The country has been down this road before and the tax practitioner's within our group still get severe headaches whenever they recall the difficulty of reconstructing the basis of business (or other) property that has been in a family for a lifetime. If the revenue were necessary to make the President's tax plan feasible, we would urge the committee to raise the threshold for property excluded from any estate tax to a sufficient level to ensure that most small businesses are completely excluded. In the alternative, we ask the committee to consider some simplified system of evaluating the basis of property (a safe harbor) that will not require weeks or months of evaluation and paperwork.

The White House Conference on Small Business Tax Issue Chairs welcome the opportunity to continue our work with Congress to suggest ideas that would help the nation's small business community. We hope Congress continues to listen to the recommendations of small businesses and analyze all legislative proposals for their impact on small businesses and their employees. Small businesses, after all, provide most of the new jobs for our economy. With this in mind, we have attached a copy of our latest "Tax Action Plan" for you and your staff to review. Thank you for your time and attention to our needs.

Sincerely,

The White House Conference Tax Chairs:
Region 1—Debbi Jo Horton, East Providence, RI
Region 2—Joy Turner, Piscataway, NJ
Region 3—Jill Gansler, Baltimore, MD
Region 4—Jack Oppenheimer, Orlando, FL
Region 5—Paul Hense, Grand Rapids, MI
Region 6—Tommy Bargsley, Austin, TX
Region 7—Edith Quick, St. Louis, MO
Region 8—Jim Turner, Salt Lake City, UT
Region 9—Sandra Abalos, Phoenix, AZ
Region 10—Eric Blackledge, Corvallis, OR

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