



Policy and Taxation Group

Congress Should Reject Treasury's "Greenbook" Estate and Gift Tax Increases

In the Treasury Department's "Greenbook" released on May 11, 2009, the Administration proposed partially offsetting the cost of health care reform with three increases in estate and gift taxes. These proposals would arbitrarily increase the tax burden on individuals and family businesses and would be inconsistent with the goal of permanent and fair estate tax relief. These three changes include:

1. Limiting Valuation Discounts.
2. Increasing Reporting Requirements for Small Family Businesses.
3. Placing New Restrictions on a Planning Technique Previously Approved by Congress.

Limiting Valuation Discounts

Upon the death of a loved one, families spend significant resources and time determining their estate tax liability by establishing the full value of the deceased person's estate. Through common and statutory law, states have long established that certain restrictions on the rights of owners, such as restrictions on an individual's ability to sell or make use of property, reduce the *actual* value of property for which there is no ready market. States have recognized that when an owner is limited by factors such as the lack of marketability of an asset or the lack of control over property, the property is worth *less* to the owner in both economic and practical terms. Since restrictions reduce the property's actual value, families have long been able to discount the value of restricted property for estate tax purposes. This common sense approach merely reflects the same considerations that a third party would take into account in purchasing property for which there is no ready market.

The Greenbook proposes increasing the estate tax by overriding these long-recognized state standards on property restrictions with a new federal standard developed by the Treasury Department. Specifically, the Greenbook seeks to create an additional category of "disregarded restrictions" that would be ignored in valuing interests in family-controlled entities. The government would be able to disregard limitations, such as those on an individual's ability to sell or make use of property, that are more restrictive than the new federal standard. The proposal would apply only to family businesses, preventing them from using well-established valuation discounts based upon commonly accepted economic principles that would still be available to third party interests. Congress should refuse to adopt this proposal because it would:

- Increase the already heavy burden of the estate tax on family businesses,
- Usurp the rights of states by legislating on the federal level the value of property rights granted under state law,
- Ignore the economic reality of the reduced *actual* value of restricted property,
- Single out family businesses for disparate treatment, and
- Be difficult and costly to administer.

Increasing Reporting Requirements for Small Family Businesses

When an individual purchases, holds for at least one year, and then sells an asset, he or she must pay a capital gains tax of 15% on the asset's increase in value. When an individual purchases and holds an asset until death, the asset is added to all other assets to calculate the value of the deceased person's estate and estate tax. Instead of paying taxes on the decedent's capital gains, families must pay a 45% tax on the estate's value that exceeds the exemption allowed by law

(currently \$3.5 million). To avoid imposing both an estate tax on appreciated property and a capital gains tax on the same property, a “step-up-in-basis” occurs, meaning that the family’s future capital gains tax liability is based on the value of assets at the decedent’s death instead of the value of assets when purchased by the decedent.

For example, in 1990 an entrepreneur purchased a dry cleaning business for \$200,000. When the entrepreneur died in 2005, the business had appreciated in value and was worth \$500,000. The value of the business was added to the value of all other assets of the entrepreneur, and the family paid estate taxes at 47% (the rate in 2005) on the value that exceeded the exemption. While the entrepreneur’s basis during life was \$200,000, the family’s basis after her death was \$500,000. In 2009, the family sold the business for \$600,000 and paid capital gains taxes based on the appreciation in value since death (\$100,000), instead of the appreciation since original purchase (\$400,000) because the previous gain had already been taxed as part of the estate tax.

When families pay the estate tax, the “stepped-up” basis in property they receive is well-documented on their estate tax returns. The Greenbook proposes increasing capital gains tax collections by requiring families who do not have to file estate tax returns to report to the IRS the “stepped-up” basis of inherited property at death. The measure would also require “consistency” to ensure recipients could not report a higher basis when paying capital gains taxes than that which was applied at the decedent’s death. Through the changes, the government would shift more of the burden of enforcing the law onto smaller taxpayers, who would have to assess the value of assets, file new forms and comply with new regulations as they cope with the death of a loved one. This is contradictory to the goal of increasing the exemption to \$3.5 million or higher in order to reduce the burden of both paying the estate tax and filing the forms to comply with the estate tax.

Placing New Restrictions on a Planning Technique Previously Approved by Congress

Congress specifically permitted several techniques, including grantor retained annuity trusts (GRATs), in 1990 as a way to permit a person to retain the use of an asset for a period of time and then pass the asset down to family members or third parties. Through a GRAT, a transferor makes a gift of property to a transferee while retaining an annuity for a fixed term of years. The value of the gift is calculated as the difference between the value of the retained annuity and the value of the transferred property. GRATs only work when the property actually increases in value and the taxpayer survives the term of the trust. Congress recognized that it was unfair to tax a gift at its full value when the donor retains the right to the use of the asset for a period of time. GRATs are often used to transfer interests in a family business from an older generation to a younger generation to ensure continuity of ownership and to avoid the need to sell a business to pay the estate tax when an older generation family member dies.

The Greenbook proposes increasing estate and gift taxes by requiring GRATs to have a minimum term of at least ten years, thus decreasing the likelihood that taxpayers will survive and receive any benefit from the technique. Since GRATs have been specifically permitted by statute as a long-established and legitimate planning technique, Congress should not increase the already heavy burden on family businesses by restricting their use.

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