Testimony

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On

Planning for the Death Tax: Can Small Businesses Survive?

Before the

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Chairman Walsh and Ranking Member Schrader. Thank you for inviting me to address this committee. My name is Thala Taperman Rolnick and I am a Certified Public Accountant from Phoenix, Arizona where I have specialized in Estate, Trust and Gift tax for the last 16 years.

HISTORY OF THE ESTATE TAX

Estate taxes have been around since the Egyptians assessed it in early 700 B.C. In 1797, the U.S. Congress funded the war with France by passing an estate tax stamp system.

In 1898, a Federal legacy tax was proposed as a way to raise money to fund the Spanish-American War. Unlike the previous Federal "death taxes" levied in times of war, the 1898 tax proposal provoked heated debate. It had the following progressive rates that varied by beneficiary type.

1898 Legacy Tax Rates

Relationship	$10,000 to $25,999	$25,000 to $99,000	$100,000 to $499,999	$500,000 to $999,999	$1,000,000 or more
Lineal decedents, ancestors, siblings	.7500	1.125	1.500	1.875	2.250
Descendants of siblings	1.500	2.250	3.000	3.750	4.500
Uncle, aunt and their descendants	3.000	4.500	6.000	7.500	9.000
Great uncle, aunt and their descendants	4.000	6.000	8.000	10.000	12.000
All others	5.000	7.500	10.000	12.000	15.000

When the Spanish-American War ended, the tax was repealed.

Progressives, including President Theodore Roosevelt advocated both an inheritance tax and a graduated income tax as tools to address inequalities in wealth. It wasn't until World War I, that Congress enacted the Revenue Act of 1916. This initiated the permanent tax on the transfer of wealth from an estate to its beneficiaries.

Those in favor of the tax have said that this was an effective tool to raise money and prevent the concentration of wealth and power within a few families. Like today, others said that the transfer tax discouraged capital accumulation and that it curbed national economic growth.

THE CURRENT ESTATE OF THE ESTATE TAX

The question at issue today is, "can a small business survive the estate tax?"
The answer is "it depends." The estate tax has been a moving target since 2002. The amount that could pass estate tax free before 2002 was only $600,000 per person. The

current amount is $5,120,000. At the end of this year, that amount will drop to $1million per individual unless Congress acts. The exclusion amount enacted will determine how many small businesses will be affected.

Over the last 10 years, a number of extremely wealthy families have done an excellent job of convincing small business owners into believing that they will lose their businesses to the estate tax. In reality, at its current level, it affects very few individuals. In 2010, when the exclusion amount was $3.5 million, the Centers for Disease Control and Preventions determined that 2,437,163 people died. According to IRS statistics, only 15,191 of these individuals were required to file an estate return. Of those, only 6,711 paid any estate tax. Of those paying the estate tax, only 4,425 returns included general partnerships, sole proprietorships, closely held C-corporation stock, farms and S-corporation stock. The total tax collected from all returns was $69,151,158,000.

The most current IRS statics showing the type of income earned by taxpayers is for 2009. There were 22,111,784 returns showing business and professional income. This number does not include returns where the taxpayers owned privately held C-corporations. Just using these numbers, which probably overstate the actual percentage, only .02% of small business estates were even subject to the estate tax at a $3.5million exclusion. At a $5million exclusion, even less will be subject to the tax. Of course if Congress allows the exclusion to revert to $1million, based on 2002 numbers, almost 26,000 small business owner estates will be subject to estate tax annually and this now does become a major small business issue.

CURRENT ESTATE PLANNING TECHNIQUES

For years, we have heard about the expense that small business people had to incur, for legal and accounting fees, to save their businesses from the estate tax. The three most talked about methods are grantor trusts that become irrevocable at death, family limited partnerships and irrevocable insurance trusts.

The estate planning advantage of a revocable grantor trust only works if the first to die is a spouse that has wealth. Their share of the assets are place into an irrevocable trust, usually up to the exclusion dollar amount. Once in the trust, the assets can grow without ever being subject to the estate tax again. Prior to death, the cost incurred would be attorney's fees for preparation and periodic review of the provisions of the trust based on law changes and life changes. Once the taxpayer passes away, an annual trust return will need to be prepared.

Beside the estate planning advantages, there are good reasons why everyone should incur the expenses to have a trust. First, when funded properly, it is the trust that owns the asset of the decedent. This allows the estate to avoid the cost of probate. Next, if the owner of the assets can no longer handle his or her own affairs, the successor trustee can step in without going to court to become appointed as guardian/conservator. With a conservator/guardian, additional costs must be incurred annually. These include annual court accountings and annual bond fees.

Once the trust becomes irrevocable, the trust assets are protected from the beneficiaries' creditors. If the decedent is afraid that the beneficiary of his/her estate, may use the assets unwisely, the trust may allow distributions only for an ascertainable stand such as health, education, maintenance or support.

In today's society many individuals marry two or more times. They want to provide for their current spouse, but they want to preserve their assets for children of prior marriages. Trusts allow them to do this.

The second largest estate planning technique is to place the assets in a family limited partnership. These have received a very bad reputation because wealthy families would place highly liquid assets into this type of entity, rather than business assets, and gift interests to their children. By gifting a partnership interest, rather than an interest in the underlying assets, they were able to reduce the value of the gift due to a lack of marketability of the partnership interest and lack of partner control. In many cases, these discounts resulted in the value of the gift being 60% to 30% of the actual value of the underlying liquid assets. As soon the parents passed away, the children distribute the assets. When they would sell them, they would pay a greater capital gains tax, but that rate has always been much lower than the estate tax rate. Because of this perceived abuse, there have been Congressional and Presidential suggestions that all discounts, where family members jointly own entities, should be disallowed.

Unlike with investment partnerships, it is a very different story when an active business owner passes away. Here, there is truly a loss of value to the business. I saw this in my own family.

My father-in-law and his brother owned a successful dress manufacturing business. My father-in-law ran the inside operations, his brother was the sales person. When Joe died, there was no one to run operations. It took months to find a replacement. Even then, he did not have the relationship with the seamstresses that Joe had. Many quit, productivity suffered, relationships with buyers were strained and customers were lost. Because of Joe's death, the value of the business decreased. That needs to be accounted for in the date of death valuation.

While a general partnership is not required to have any formal documents, I fully recommend they do and that they be prepared by an attorney. There are different requirements for limited partnerships and LLCs that may require additional legal attention. Once a partnership is set up, annual partnership returns must be filed.

The third technique most often used is an irrevocable life insurance trust. Life insurance can be purchased on the business owner's life. If done properly, the life insurance is excluded from the business owner's estate and the money can be used to purchase estate assets, providing liquidity to pay any estate tax.

Again, legal fees must be incurred to set up the entity. The insurance must be purchased and paid for. If gifts are made annually to the trust, special letters must be sent to the beneficiaries and a gift tax may be required to be filed.

PORTABILITY

When the current estate law was passed in 2010, it attempted to reduce the need for some of these techniques buy trying to make the exclusion amount more of a "family" exclusion rather than two individual exclusions by initiating portability. Prior to this enactment, if the "poor" spouse died first, that person's unused exclusion amount was lost. This provision allowed any unused estate exclusion of someone dying in 2010, 2011 or 2012, to pass to their surviving spouse. While the idea is admirable, the legislation is flawed in many ways.

First, it applies only to the estate tax and not to the generation skipping tax. Therefore, if the second spouse to die has a large enough estate to use the extra exemption and they want to leave those assets to their grandchildren, they will need to either pay the GST immediately or set up an additional trust that will have to pay the tax when the assets are distributed to skipped beneficiaries.

Second, to be eligible for portability, the estate of the decedent must file an estate tax return. The estate tax return form is a very long and very complex and the IRS has not developed a "simple" estate tax return for this scenario. In addition to filing the form, the statute of limitations remains open on the value of the assets until the second spouse dies. That could be 5, 10 or even 50 years later. After all those years, valuation calculations and the documentation used to determine the value could have easily disappeared.

Next, there are marriage restrictions. When portability was initially proposed about 7 years ago, the surviving spouse could "accumulate" up to a full second exclusion. For example, suppose my first husband died and left me $4million of unused exclusion. I later meet a wonderful man, fell in love and got married. Unfortunately he also dies before me, leaving his unused exclusion of $2million. Under the old proposal, I would now be able to combine those amounts up to the current $5million exclusion.

Under the current law, this does not happen. Instead, I could lose my first husbands unused amount. In the example above, I would only end up with an additional $2million. Assuming the same man has assets of $6million. He has children from a prior marriage. Therefore, he plans to utilize his $5million exclusion for them. If I marry him and he dies first, I lose my first husbands exclusion amount and I am left only with my own resulting in estate tax when I die. Many people put in this situation might chose not to marry and to just live together.

Many people are now afraid to make the portability election. They are afraid that the above situations will occur. They also question what will happen if Congress allows the provision to expire. Will they still be allowed to use that extra exclusion or will it just disappear too?

Finally, portability does not protect against an increase in value of the inherited assets. Let's assume that my husband and I jointly own assets worth $8million. Let's also assume that the estate tax exclusion remains at $5million. If I place my husband's $4million in a trust when he dies and it grows to be $15million, it will never be subject to estate tax again. If I chose portability and my assets did not grow at all, when I die, my estate will be worth $19million (my $4million plus my husbands $15million) and only $10million would be protected from estate taxes.

Because of the above additional work, uncertainty and potential additional tax liability, many professionals are recommending against using this provision as it is currently enacted.

STATE ESTATE TAX AND INHERITANCE TAX

We also need to remember that the estate tax does not only apply at the federal level. Many states have either an estate tax or an inheritance tax. As of November 2011, 22 states and the District of Columbia impose one of these two taxes. Only 1 state has tied their exclusion to the federal amount. All the other states have "disconnected" and impose tax on estates as low as $1million.

CURRENT TAX CODE PROVISIONS THAT HELP SMALL BUSINESSES

The current code does provide some favorable provisions for estates of small business owners. The first is Section 2032A. This provides that land used in a business or as a farm may be valued at its current use instead of its best and highest use value. To qualify, the land must be at least 25% of the adjusted value of the decedent's gross estate and that 50% of the adjusted value of the decedent's gross estate consists of real or personal property used in the business. The decedent or family member must has materially participated in the business and used the real property for a qualified use for five of the eight years prior to death. A member of the family must continue to own the property and continue to materially participate in the business that employs the property for 10 years following the decedent's death. If it is disposed of early, the additional estate tax will become due. The maximum decrease in value that will be allowed is $1,040,000 for those dying in 2012.

Section 6166 allows estates of certain closely held businesses and farms to pay the portion of their estate tax, attributable to the business or farm over 15 years. To qualify, the value of that interest must be more than 35% of the decedent's adjusted gross estate. Under this election, that portion of the estate tax must be paid in 10 or fewer equal annual installments. Interest payments must start immediately, but the first installment of the tax may be deferred for up to five years after the regular payment due date. Succeeding installments must then be paid annually on or before the same date until the tax is paid in full.

Next is Section 2057. This provision became obsolete when the estate tax exclusion increased above $1million. It provided an additional unified credit when a business was left to a family member. If the estate tax reverts to $1million, this provision will become

active again. While it is intended to help small businesses, it is an extremely difficult to calculation and the calculation can not be done prior to death. Therefore, the family can't use it as an estate planning tool.

GIFT TAX

In 2004, Congress decided to disconnect the gift tax from the estate tax. When total gifts exceed $1million, a tax becomes due. The theory back then was that people will gift income producing property or assets with a high possibility of increasing in value before they died, so this must be limited. For 2011 and 2012, gift and estate tax have been reconnected at the $5 million limit. That makes it an excellent time for business owners to start passing a portion of their business to the next generation.

EXPIRING ESTATE PROVISIONS

Almost all the conversation regarding the estate tax for 2013 focuses around the actual decrease in the exclusion, the increase in the rates, the disconnecting of the estate tax and the gift tax and the disappearance of portability. There are a number of other estate tax provisions that will also expire.

The first is the modification of estate and gift taxes to reflect the differences in credit resulting from tax rate changes. (IRC 2001(b)(2), 2001(g) and 2505(a)) When we calculate the estate tax, we add back all prior gifts and calculate the estate tax on the total. These provisions tell us to use the current estate tax rate, that is lower than a rate that may have been paid with a gift tax return in a prior year. For example, if I made a taxable gift in 2001, I paid gift tax at a rate of 55%. Today's rate is 35%. I don't get credit for the extra 20% I paid against the current value of my assets that I am leaving to my heirs.

The second provision to expire is the provision that replaced the credit for estate taxes paid to a state with a deduction. (IRC 2011, 2053,2058,2102,2106 and 2604)

The third provision that is scheduled to expire is the expansion and clarification of estate tax conservation easement rules (IRC. 2031(c)(2), (c)(8)(A)(i)). It repeals certain restrictions on the location of land. Additionally, the expiring provision clarifies the date to be used to determine the value to be taken into account for determining the exclusion from the gross estate.

The next expiring provision provides for the treatment of qualified severed trusts as separate trusts, modifies certain valuation rules, and provides relief for certain late elections. (IRC 2632(c) and 2642(a)(3), (b)(1), (b)(2)(A), and (g)). Unless the estate elects otherwise, this provision allocates any unused GST exemption to indirect skips.

As stated earlier, a small business may qualify to pay their estate tax over 15 years. The expiring provision increased the number of allowable partners and shareholders in a closely held business from 15 to 45, expands the availability of the installment payment provisions to include interests in qualifying lending and finance businesses, and clarifies

that in order to qualify as holding company stock, stock must be non-readily-tradable stock. Therefore, businesses will have to continue using the methods they have used in the past to protect the value of their business and to make sure there are sufficient funds to pay any potential estate tax unless these provisions are extended.
(IRC 6166(b)(1)(B)(ii),(b)(1)(C)(ii), (b)(8)(B), (b)(9)(B)(iii)(I), and (b)(10)).

RECOMMENDATIONS

Most small business owners are very resourceful and find ways to resolve challenges to their businesses. But when they don't know what to plan for, planning becomes impossible. There can be no estate planning until we have some permanence in the estate code. Therefore, I recommend:

1. Enact a permanent estate tax exclusion set at a rate between $3.5million and $5million per person. It should be matched for the Generation Skipping Tax and it should be adjusted for inflation.

2. Permanently rejoin the Gift and Estate Tax with the same exclusion amount.

3. Make portability permanently but also correct the statute to:

    a. Allow a surviving spouse to accumulate up to a full second exclusion.
    b. Allow portability for Generation Skipping Tax.
    c. Change the Statute of Limitations on the valuating assets of these returns to 3 years.
    d. Recommend that the IRS develop "Simple" Form 706 to establish the unused exclusion.

4. Preserve reasonable valuation discounts for operating businesses where the death of an owner truly reduces the value of the business.

5. Pass an simpler, easier and provision to replace IRC Section 2057. I would recommend a "Family Farm and Business Preservation Exemption" be enacted. It would provide an additional exemption, up to a specific dollar amount, such as $1.5million, for an interest in an operating family business with a total value under possibly $10million. By allowing this additional targeted exemption, families could better plan for business continuity. This provision should also apply to generation-skipping transfers. The added exemption, however, should probably not apply to the proportional value of business liquid assets and marketable investments exceeding 6 months of normal business operating expenses, based on the prior year tax return. There should be prorated recapture of this added exemption amount if the business interest is sold to a non family member within 10 years.

6. Pay for making these provisions by permanently:

    a. Readjusting the Estate Tax rate brackets to restore progressivity above the exemption level to provide better fairness for smaller estates. For example, apply a 15% rate to individual taxable gift and estate transfers below $1M, a 25% rate between $1 and $3.5M, a 35% rate between $3.5M and $5M, a 40% rate from $5M to $7.5M, a 45% rate between $7.5M and $10M, a 50% rate between $10M and $15M, and a 55% or higher rate on estates above $15M. Estates below a $3.5M exemption would still pay no actual tax.

    b. Reform the Grantor Retained Annuity Trust (GRAT) provisions and pass limitations on excessive discounts where they hold primarily liquid securities.

Thank you for your time and I would be glad to answer any of your questions.

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