AN OVERVIEW OF THE EFFECT OF THE BIDEN TAX PLAN ON SMALL AND FAMILY BUSINESSES

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President Biden has proposed significant changes to the federal estate tax (also known as the death tax).[1] The President's proposal, the Biden Tax Plan, contains four important moving parts.[2] The plan:

- eliminates stepped-up basis rules imposing Capital Gains Tax plus the Federal Estate Tax;
- taxes assets rather than profits;[3]
- collects capital gains tax at death, regardless of whether the gains are realized;
- raises the top Capital Gains Tax rate from 20% to 43.4% (this includes the 3.8% Net Investment Income Tax – also known as the Medicare surtax – that applies to unearned income over $200,000).[4]

The largest effect of the Biden Tax Plan is the creation of what would amount to a "second-tier" estate tax on working- and middle-class households. While described as a "capital gains tax," combining the tax with the requirement that it be paid at death and the elimination of stepped-up basis rules creates an effect identical to the estate tax – albeit aimed at lower income households. The "Double Death Tax."

The "Working Class" Death Tax

Capital gains taxes are not indexed or adjusted for inflation. For example, under current law, an asset purchased in 1980 for $50,000 and sold in 2021 for $150,000 would be subject to as much as $20,000 in capital gains taxes even though, adjusted for inflation, the asset was sold at a loss. Stepped-up basis attempts to eliminate this inflation bias by resetting the clock on the asset's value upon inheritance. Under existing stepped-up basis rules, when an heir sells an inherited asset, the heir pays capital gains tax on the difference between the value at sale and the value at inheritance. With a proposed $1 million exemption, removing the step-up rule effectively creates a "working class" death tax that has the potential to ensnare frugal, and decidedly not-rich, households.

[1] https://www.nytimes.com/2021/09/07/us/politics/biden-tax-increases.html
[2] https://taxfoundation.org/american-families-plan/
[3] https://www.wsj.com/articles/bidens-new-death-tax-and-a-new-york-widow-11623616078
[4] https://www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax

For example, consider a person who began working at age 20 in 1972, earned (adjusted for inflation) a constant $50,000 per year, saved 15% of his income, and invested in a broad portfolio of stocks represented by the Wilshire 5000 index.[5] By 2020, this person would have amassed total savings of over $1.5 million. A $50,000 household income is on the border between lower-middle and middle income.[6] Suppose that, in 2020, the worker dies leaving the $1.5 million portfolio to an heir. With stepped-up basis, the heir could immediately sell the stock tax free. By removing stepped-up basis, the heir would owe 20% tax on the difference between the $1.5 million portfolio value and the $219,000 the worker invested over the years. Removing the stepped-up basis costs the heir more than $268,000 in taxes.

Taxing Assets Rather Than Profits

A further complication is that Biden's plan, at least where homes are concerned, taxes assets rather than equity.[7] This means that an heir who inherits a flly mortgaged $200,000 house can owe up to $40,000 in capital gains taxes even though, net of the mortgage, the house is worth nothing. This complication puts the "death" squarely in "death tax" as, in an example like this, the government is taxing someone merely for dying.

Double Death Tax

While classified as a Capital Gains Tax, removing the stepped-up basis effectively creates a new second-tier death tax – one that is aimed at the working- and middle-class families. For estates over $11.7 million, heirs would pay 40% Estate Tax plus 43.4% Capital Gains Tax (including the Medicare surtax and the removed stepped-up basis). For estates between $1 million and $11.7 million, heirs would pay 43.4% Capital Gains Tax. This is a new death tax on working families.

Removing the stepped-up basis reduces the return to savings – possibly even making the return to savings negative given that the capital gains tax does not adjust for inflation. The effect of this piece of the proposal will be to discourage savings and investment,

[5] hhttps://fred.stlouisfed.org/series/WILL5000PR

[6] https://www.taxpolicycenter.org/statistics/household-income-quintiles

[7] https://www.wsj.com/articles/bidens-new-death-tax-and-a-new-york-widow-11623616078

and so reduce heirs' standard of living, entrepreneurship, job creation, prosperity and federal tax revenues..

Favoring Publicly Traded Corporations Over Small and Family Businesses

Taxing an asset at death, regardless of whether the asset is sold, can force heirs to liquidate the assets of their businesses. Taxing at death plus removing the stepped-up basis each, independently, will reduce the number of family owned businesses relative to publicly traded corporations.[8] Removing stepped-up basis means that an heir who inherits business assets and an heir who inherits stock of the same value will both owe the same tax. Taxing at death puts equal pressure on each heir to sell a portion of the inheritance to pay the tax bill. But, the effect on the underlying family owned businesses is very different. The heir who sells some of the inherited business assets will diminish the business' ability to continue functioning. The heir who sells some of the inherited stock will have no effect on the publicly traded corporation. These taxes will have the effect of slowly replacing family businesses with Wall Street traded corporations.

As of 2021, the average household among the top 40% by wealth, had a net wealth of over $740,000, and the average wealth among the top 10% was over $4.4 million.[9] Consequently, somewhere between 10% and 40% of households could be subject to capital gains taxes on inherited unrealized gains. The heirs to these households – particularly those lower on the income scale who are, nonetheless, hit with the unrealized capital gains tax – will find themselves being forced to sell assets to pay taxes. This could cause tremendous disruption or destruction to small and family businesses and the jobs they provide.

At the current $11.7 million exemption, the threat of the tax affects family business owners' investment decisions regardless of whether the tax is triggered, making the potential impact of the estate tax far greater than the number of taxed estates.[10] For the moment, there appears to be pressure to decrease the estate tax exemption, however,

[8] Yakovlev, P.A. and A. Davies, 2014. How does the estate tax affect the number of firms? Journal of Entrepreneurship and Public Policy, 3(1): 96-117.

[9] https://www.federalreserve.gov/releases/z1/dataviz/dfa/distribute/chart/

[10] https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax

the proposed $1 million exemption for unrealized capital gains will capture many of the almost two million small and family businesses.[11] Collectively, those businesses support almost 50 million American jobs.[12] This combination of eliminating the stepped-up basis and requiring that capital gains taxes be paid at the point of death will cause this "second-tier death tax" to hit many more households, and have the unintended effect of reducing the number of small and family businesses in favor of publicly traded corporations.

Increasing the Death Tax Rate: Devastating Family Farms & Ranches

The Agricultural and Food Policy Center maintains a database of 94 representative farms across 30 states. Based on these representative farms, the AFPC estimates that removing stepped-up basis would increase from 2% up to 98% the fraction of farms owing tax in the event of death and generational transfer.[13] AFPC also estimates that the additional tax liability would average around $726,000 per farm. While the AFPC analysis does not account for the Biden plan's proposal to "protect family-operated farms and businesses" by deferring the capital gains tax until the farms and businesses are sold, this protection merely defers the tax. It does not eliminate the tax. The Internal Revenue Service will file a tax lien against the family farm or business thus affecting their ability to borrow and grow.

Independent estimates of the revenue Biden's plan would raise indicate that the plan would cost families up to $400 billion in death taxes over a decade, or an average of $40 billion per year.[14] In 2020, federal estate tax revenue totaled $17.6 billion.[15] Relative to the current law, these estimates represent an increase in annual estate taxes of up to 127%. Estate tax prediction models estimate that the increase in estate tax revenues would cause a slowing in growth of the number of businesses by as much as 7 percentage points, cumulatively, over the next six years.[16] For comparison, in the years leading up to the covid lockdowns, the number of firms with paid employees grew at a median rate of around 2% per year.

[11] https://taxfoundation.org/biden-small-business-tax/

[12] https://fred.stlouisfed.org/series/NPPTTL. According to Survey of Business Owners data, 42% of private-sector workers are employed by family-owned businesses..

[13] https://republicans-agriculture.house.gov/uploadedfiles/rr-21-01-afpc-tax7.pdf?utm_campaign=2800-396

[14] https://www.bloomberg.com/news/articles/2021-09-10/biden-inheritance-tax-plan-poised-to-be-scaled-back-in-congress

[15] https://www.cbo.gov/publication/57129

.[16] Yakovlev, P.A. and A. Davies, 2014. How does the estate tax affect the number of firms? Journal of Entrepreneurship and Public Policy, 3(1): 96-117.

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