Consequences of Republican Tax Policy:

Prepared by the Democratic Staff of the Committee on Ways and Means
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April 12, 2005

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I. <u>Greater Unfairness:</u>
<u>The Inequity of the Bush Tax Cuts</u>

"Since 2001, President Bush's tax cuts have shifted
federal tax payments from the richest Americans
to a wide swath of middle-class families."

"Tax Burden Shifts to the Middle,"
Jonathan Weisman,
<u>The Washington Post</u>, August 13, 2004

The 2001 and 2003 Bush tax cuts reduced the progressivity of the Federal income tax and the Federal tax system in general. The Bush tax cuts were "regressive" in two fundamental ways: first, because they reduced tax rates at higher income levels more than at lower levels; and second, because they dramatically reduced the taxation of capital income in a number of ways — including cuts in dividend and capital gains taxation and eventual repeal of the estate tax.

Both the Urban-Brookings Tax Policy Center and the Congressional Budget Office (CBO) have shown that the tax cuts were disproportionately skewed to the rich, and that by any appropriate measure of tax incidence, progressivity was clearly reduced as a result of the 2001 and 2003 tax cuts.

The Administration continually claims that their tax cuts were "progressive." But the only statistic they rely on to make this claim is the richest households' "share of income taxes paid," which is a misleading statistic in terms of evaluating tax incidence, or how people are burdened by taxes, because it ignores how taxes paid compare to ability to pay. Our society's established standard of fairness in taxation is progressivity, characterized by taxes *relative to income* (a measure of ability to pay) *rising* with income. The rich may have ended up paying a slightly larger share of a *much* smaller tax pie, but that means that the tax cut to them was huge, even relative to their income. We should hardly characterize this as evidence of the rich bearing a "greater tax burden" or the tax system becoming "more progressive."

In fact, the share of income taxes paid statistic doesn't always support the Administration's claims. CBO's most recent update (March 2005) of their historical effective tax rates analysis (based on actual tax return data) shows that it was *middle-income* households, *not* the richest households, who paid a higher share of Federal taxes following the 2001 tax cuts. The middle 20 percent's share of individual income taxes rose from 5.2 percent in 2001 to 5.3 percent in 2002, and their share of all Federal taxes rose from 10.0 percent in 2001 to 10.2 percent in 2002. (Meanwhile, the richest 1 percent saw their individual income tax share *fall* from 34.4 percent in 2001 to 33.0 percent in 2002, and their share of all federal taxes *fall* from 22.7 percent in 2001 to 21.1 percent in 2002.)

When examining more appropriate measures of tax burdens which relate taxes to ability to pay, it is clear that the Bush tax cuts were regressive, not progressive. Why? Because average tax rates declined more, and after-tax incomes rose more — and in percentage, not just absolute terms — for higher-income households. The progressivity of the income tax system and of taxes overall has *declined*.

The CBO and Tax Policy Center distributional analyses differ somewhat in the time frame examined and in which tax cuts are included. CBO's analysis includes the distributional effects of (temporary) bonus depreciation but does not include the effects of estate tax reduction. The Tax Policy Center often accounts for the estate tax but does not distribute the benefits of bonus depreciation.

CBO's calculations imply that in 2004 alone, the tax cuts to the top 1 percent of households (with incomes averaging over $1 million) were worth nearly $80,000 or 10.1 percent of their after-tax income on average. Meanwhile, the bottom 20 percent of households (with incomes averaging less than $17,000) received only a $250 tax cut on average, or just 1.6 percent of their after-tax income.

CBO's analysis shows that the effective Federal tax rate for the top 1 percent fell from 33.4% without the Bush tax cuts, to 26.7% with the tax cuts (or a reduction of 6.8 percentage points). In contrast, the effective Federal tax rate for the bottom 20 percent fell from 6.7% to 5.2% (or by 1.5 percentage points).

The Tax Policy Center's analysis, as described in a Tax Notes article by Bill Gale and Peter Orszag, shows that the distribution of a permanent version of the Bush tax cuts (including income and estate tax reductions) is highly regressive based on the changes in effective (average) tax rates and percentage changes in after-tax income. In 2010, the top 1 percent receive a 4.3 percentage point reduction in their average tax rate, while households on average receive just a 2.6 percentage point reduction, and the bottom 20 percent receives only a 0.3 percentage point reduction. The top 1 percent receive a 6.4 percent increase in after-tax income, while households on average receive a 3.4 percent increase, and the bottom 20 percent receives a 0.3 percent increase.

The Tax Policy Center's analysis also demonstrates why the "share of income taxes paid" statistic is misleading and can move in opposition to appropriate measures of progressivity based on ability to pay. (See Appendix A.)

Millionaire Tax Cuts: Even without accounting for the reductions and repeal of the estate tax, the Tax Policy Center estimates that the 2001 and 2003 income tax cuts, if made permanent and if Alternative Minimum Tax (AMT) relief is extended, result in an average tax cut in 2010 (alone) of more than $125,000 (or a 6.0 percent average increase in after-tax income) for households whose incomes currently exceed $1 million. Meanwhile, the average tax cut in 2010 over *all* households is just over $1,500, or an average 3.1 percent increase in after-tax income.

Most recently, the Tax Policy Center has determined that the 2001 and 2003 tax cuts, if made permanent, will cost over $2.8 trillion over the 2001-15 period:

- Of the $2.8 trillion in tax cuts over 2001-15, $863 billion, or more than 30 percent, goes to the top 1 percent of households alone. These are households with incomes averaging over a million dollars (or a *minimum* of more than $350,000) in 2004.

- Of the $2.8 trillion in tax cuts over 2001-15, $1.5 trillion, or more than half, goes to the top 10 percent of households alone (incomes exceeding $112,000 in 2004).

Moreover, these distributional results ignore the burden of the increased Federal debt. The regressivity of the Bush tax cuts is even worse when one accounts for the fact that these tax cuts directly increased deficits and the debt, and hence must be paid for eventually with some combination of spending cuts and/or tax increases. Such a combination of tax and spending changes is likely to be less progressive (more regressive) that the current distribution of tax burdens. Hence, accounting for the costs associated with deficit-financed tax cuts would increase the measured regressivity of those tax cuts, as an analysis by the Tax Policy Center (Gale and Orszag) has demonstrated.

Effects of Fundamental Tax Reform? We're Already Halfway There.

The Administration is now considering options for fundamental tax reform, or a switch to a broader-based, lower-marginal-rate tax system. The GOP vision for tax reform calls for replacing the current income tax system (and sometimes payroll taxes as well) with a pure consumption-based tax, such as a national sales tax.

The Bush tax cuts have sometimes been referred to as "stealth fundamental tax reform," because they have already drastically reduced the taxation of capital income relative to labor income. In their analysis of the President's budget, CBO reports that the effective marginal tax rate on labor income is currently (tax year 2005) 26.7 percent, while the effective marginal tax rate on capital income is only about half that–just 13.8 percent. Under the President's tax proposals, the effective tax rate on labor income would rise to 29.4 percent by 2010, while the effective tax rate on capital income would fall to 13.6 percent.

So the Bush tax cuts already have involved a considerable shift away from capital taxation and towards increased taxes on wage income. Republican proposals for fundamental tax reform would just further reduce the effective tax rate on capital to something closer to zero.

This base change alone is a regressive change, because lower-income households consume more of their income than do higher-income households. This is true even on a longer-run or lifetime basis, because higher-income households are more likely to consume less than their lifetime's worth of income and pass wealth on to their heirs.

A switch to a pure consumption-based tax would include a tax on existing wealth as well as a tax on labor income. To the extent that existing wealth is exempted from the new tax (due to fairness concerns), labor income will have to be taxed even more heavily (at higher rate), and the burden on younger workers will be increased. In other words, a consumption tax with transition relief becomes a wage tax.

If the replacement system involves a flatter rate structure, either because it's collected at the business level or because the personal tax involves a single marginal tax rate, this rate structure change is also regressive, because the current system of graduated marginal tax rates does a lot to add progressivity to the income tax at higher income levels.

II. <u>Exploding National Debt</u>

"We could be in a situation in the decades ahead in which rapid increases in the unified budget deficit set in motion a dynamic in which large deficits result in ever-growing interest payments that augment deficits in future years. The resulting rise in the Federal debt could drain funds away from private capital formation and thus over time slow the growth of living standards."

Alan Greenspan, Chairman
The Federal Reserve Board,
Testimony Before the House Committee on Budget,
Economic Outlook and current fiscal issues,
February 25, 2004

When President Bush took office in 2001, the fiscal position of the Federal government was extraordinarily favorable.

At that time, the Congressional Budget Office projected that the Federal government would run surpluses in each fiscal year 2002 through 2011. The total of the surpluses for those years was estimated to be $5.6 trillion. Each of those fiscal years had a projected on-budget surplus, meaning that the entire surpluses in the Social Security system would have been preserved and not spent for other purposes.

In January 2001, the national debt (references to the national debt exclude the amounts owed to Social Security and other Federal trust funds) was approximately $3.4 trillion. The amount of that debt was projected to decline rapidly, with the Federal government projected to have no net debt after FY 2008. Federal Reserve Board Chairman Alan Greenspan publicly expressed concerns over the possible total elimination of the national debt, citing potential difficulties in implementing monetary policy.

The attack on the World Trade Center, the wars in Afghanistan and Iraq, and lower than anticipated economic growth dramatically changed the budget outlook. In the past, the nation has responded to such challenges with shared sacrifice. This time, the fiscal policy emphasizing large tax reductions was unchanged. As a result, there will be large Federal budget deficits for the foreseeable future, with an exploding national debt.

Currently, the national debt is approximately $4.6 trillion, an increase of more than one third since 2001. Interest on the national debt this fiscal year is more than 15% of the total amount collected from corporate and individual income taxes. By 2010, interest on the national debt could be nearly 20% of the total amount collected in corporate and individual income taxes.

The debt burden faced by the Federal government will dramatically worsen in the future if the Bush tax cuts are made permanent. The Government Accountability Office projects that interest on the national debt would nearly equal total Federal revenues (including income and payroll taxes) in 2040 if the recent tax cuts are made permanent.

Increasingly, the United States is relying on borrowing from foreign interests to cover our budget deficits. More than 90% of the increase in the national debt occurring during the Bush Administration has been financed by foreign investors. In 2004, foreign central banks accounted for approximately 57% of the net purchases of Federal bonds, up from 41% in 2003 and a mere 6% in 2002.

The amount merely required to pay interest on the national debt ultimately will be almost twice the amount paid in Social Security benefits. Unlike interest on the national debt, Social Security has its own dedicated taxes. Therefore, the fiscal burden of the national debt is far greater than any shortfall in Social Security.

None of the debt burdens currently faced by the Federal government are due to the Social Security system. Indeed the problem would be far worse but for the surpluses that have accumulated in the Social Security Trust Fund. If there had not been a Social Security program (neither benefits nor payroll taxes), the total amount of the national debt today would be $6.3 trillion rather than $4.6 trillion.

III. Increased Complexity

"Without a doubt, the largest source of compliance burdens for taxpayers and the IRS alike is the overwhelming complexity of the tax code, and without a doubt, the only meaningful way to reduce these compliance burdens is to simplify the tax code enormously."

National Taxpayer Advocate's
2004 Annual Report to Congress

When the Republicans took control of the House in 1994, they promised to make our tax laws simpler and more fair. Instead, the Republicans have greatly increased the complexity of our tax laws over the past decade.

Political words have not translated into legislative action for a simplified tax system. Former Ways and Means Committee Chairman Archer promised numerous times to "rip the code out by its roots" and replace it with a simpler system. Former Majority Leader Dick Armey campaigned against our tax system, favoring a flat tax to replace it. Despite repeated promises, no action has been taken to fundamentally revise our tax system. Instead, the Republicans have enacted legislation, time and time again, that dramatically increased the complexity of our income tax system, providing opportunities for those who have the means and inclination to exploit tax loopholes.

There have been numerous studies on how the tax code has become increasingly more complex and a frustrating maze for most Americans. The Joint Committee on Taxation (JCT) issued a study, The Overall State of the Federal Tax System and Recommendations for Simplification, in April 2001(JCS-3-01) which outlines the nearly 600 pages of tax simplification proposals. The Internal Revenue Service (IRS), Department of the Treasury, and IRS

Taxpayer Advocate also have issued reports and analyses of tax complexity in recent years. The Republicans have chosen to ignore these reports. As a result, we have a tax system that is quite unstable, leaving taxpayers uncertain about the law in the future.

Following are some indications of the additional complexity added by the Republicans since 1994.

- The tax code currently contains about 1.5 million words, of which hundreds of thousands have been added since 1994.

- The tax code currently has more than 5,000 pages — of which more than 500 pages have been added since 1994.

- The master Federal Standard Tax Reporter (used by accountants and lawyers as their primary source for dealing with the tax code and related IRS regulations) currently is more than 60,000 pages long — of which at least 20,000-30,000 have been added to since 1994.

- The Republicans have enacted 42 news tax laws since 1994. These new laws contain 4,268 changes to our tax code. (See Appendix B.) These changes have made the tax code significantly more complex, with an average of 427 tax code changes made each year, and no serious effort to provide simplification.

In fact, during the 108th Congress, the Republicans orchestrated nearly 900 changes to the tax code. Adoption of the Republicans' "American Jobs Creation Act of 2004," alone, resulted in 561 changes to the tax code requiring more than 250 pages of tax law changes and more than 200,000 additional words. Even the Joint Committee on Taxation's "tax complexity analysis" of the legislation describes how the new law will require more than 10 percent of all small businesses to keep additional records, result in more disputes with the IRS, increase tax preparation costs, and require additional complex calculations. (See Appendix C.)

In earlier years, the small business community also became subject to additional tax law complexity. The "Small Business Job Act of 1996" made 657 tax code changes which expanded the tax code by more than 50 pages. The "Jobs and Growth Tax Relief Act of 2003" made 51 tax code changes and expanded the tax code by nearly 12 pages. The IRS estimates that the average taxpayer with self-employed status has the greatest compliance burden in terms of preparation — 59 hours. This is about 10 hours longer than in 1994.

For the average individual taxpayer, filing an accurate tax return with the IRS is becoming harder and harder, and much more time consuming. On February 16th, John Breaux, Vice-Chairman of the President's Advisory Panel on Federal Tax Reform, stated in his opening statement that the ever-increasing complexity of our tax laws imposes an unnecessary burden on Americans. He noted that for the more than 80 million taxpayers who filled out the regular Form 1040 tax return — with its 70 lines and more than 130 pages of instructions — the task was overwhelming. What was not said was that since 1994, the number of lines on the 1040 tax return has increased from 62 to 70, and the pages of instructions has increased from 84 to 130 pages.

Today, it takes a typical American family 8 hours and 15 minutes longer to fill out their tax return than it did in 1994. This is a full day's work for most Americans. In 1994, the IRS estimated that a family that itemized their deductions and had some interest and capital gains would spend 11½ hours in preparing its federal income tax return. In 2004, the IRS estimated that such a family would spend nearly 19 hours and 45 minutes preparing it Federal income tax return.

There are numerous other examples of how complex the tax laws have become for American families under the Republicans' watch. While taxpayers benefit from many of the changes, it is unfortunate that the tax code changes increased complexity and added to taxpayers' concerns. The IRS Commissioner's 2002 report on Tax Law Complexity states that "The Taxpayer Relief Act of 1997" is an example of tax legislation that resulted in many new tax complexities. (See Appendix D.)

About 1/3 of all taxpayers claim one or more of the personal credits. The complexity involved in claiming their basic benefits are staggering. For example, a low– or middle–income family with children has to figure out how to claim the correct exemption amount, the refundable earned income credit, and the two non-refundable tax credits (i.e., child and dependent care tax credit, per child tax credit). Further, the child credit can be calculated one of two different ways.

Parents with a child in college have to choose between two non-refundable tax credits (i.e., Hope and Lifetime Learning Tax Credits) and the deduction for higher education in order to decide how best to handle their current education expenses. These provisions are computed differently with various limits and phase-outs. Parents working to save in order to send their child to college in the future have to decipher and decide between three savings mechanisms.

Even families faced with small amounts of capital gain income have to tackle the complex capital gains schedule. In earlier times, families with capital gain income could use a simple tax schedule D and apply one tax rate. Now there are a myriad of rates that must be considered, depending on the nature of the capital asset sold and the taxpayer's tax bracket.

Because of the growing complexity of our tax laws, more and more taxpayers need or choose to use professional tax preparers to complete their tax returns. In 1995, 50 percent of taxpayers filing individual returns used tax professionals. Today, 60 percent use tax preparers. This means that about 15 million additional, hardworking Americans need to obtain and pay for tax preparation services in order to deal with the tax code's complexity. For some, this average $100 to $150 cost can be a full day's wages.

Further, the Earned Income Tax Credit (EITC) is very complex. More than 70 percent of EITC taxpayers use paid professional tax preparers each year. The IRS reports that due to its complexity, the EITC is one of the most common errors made by professional tax preparers (as well as by taxpayers) in calculating the EITC. The relevant tax code Section 32 consists of 13 subsections and nearly 2,700 words. The IRS reports that it takes at least a 12th-grade education to understand how the EITC works and to fill out the numerous EITC worksheets, schedules, and forms. For the 20 million working poor individuals and families attempting to claim the EITC, innocent errors are unavoidable. (The IRS's recent EITC certification, pre-refund audit program resulted in only 23 cases of fraud, involving a handful of questionable preparers, after reviewing nearly 25,000 EITC taxpayers to see if they had complied with the tax law.) Also, nearly 5 million eligible taxpayers fail to claim the EITC each year because, as low-income tax clinic operators have found, claiming the EITC is complex, confusing, expensive, and likely to generate an IRS audit.

The costs of computer tax return software purchases have become an annual expense for many taxpayers. Each year, millions of self-preparers must purchase new, updated computer software to keep abreast of all the tax code changes. In 1990, 16 percent of tax returns were prepared using computer software. Currently, 85 percent of all returns are computer generated. It has become difficult to prepare all but the simplest tax return with pen and paper.

Community volunteer organizations have stepped in to assist taxpayers in preparing their returns. There has been a 1,000% increase in tax assistance by volunteers from 1995 to 2005, and volunteers now assist approximately 45 million taxpayers who are unable to prepare their own tax returns. The number of tax assistance classes and seminars has increased from 426 in 1995 to 37,000 in 2002.

Finally, the IRS has had to maintain taxpayer assistance programs to help taxpayers deal with the increasingly complex tax system. In 1996, taxpayers contacted the IRS for help 105 million times. By 1999, the IRS was contacted 12 million times more — about 117 million taxpayer requests for assistance. In 2004, the IRS handled over 10 million telephone calls involving specific tax questions handled by live assistants, and nearly 19 million calls through IRS's automated information systems. In coming months, the IRS will target 67 of the current 400 Taxpayer Assistance Centers for closure. The Administration's proposed budget for the IRS in fiscal year 2006 would reduce resources for taxpayer services even further.

IV. Expanding Reach of the Alternative Minimum Tax

"[The AMT] is a subsidy of the super rich
paid for by the middle class and the upper middle class."

Perfectly Legal: The Covert Campaign to Rig Our Tax System to Benefit the Super Rich – and Cheat Everybody Else,(2003)
David Cay Johnston

The Republican tax policy has resulted in a dramatic increase in the number of individuals subject to the alternative minimum tax (AMT).

In 1994, approximately 369,000 individuals (less than three-tenths of one percent) paid the AMT. Even with the temporary increase in the AMT exemption, in 2005, over 3 million individuals (about 4 percent) will have minimum tax liability. Unless that temporary increase is made permanent, approximately 30 million taxpayers (about 30 percent) will pay the minimum tax in 2010.

The explosion in the number of individuals paying the minimum tax is due to a conscious decision made by the Bush Administration to use the minimum tax to artificially reduce the cost of the 2001 rate reductions. For the first time, many individuals face higher marginal rates in the minimum tax than in the regular income tax. Those higher marginal rates, coupled with a broader tax base, is the reason for the explosion of AMT taxpayers.

The explosion in the coverage of the minimum tax is made clear by an estimate that by 2008, AMT revenue will have grown so rapidly that it will cost more to repeal the AMT than the regular income tax!

Both CBO and the Tax Policy Center have highlighted how the AMT will take back much of the tax cuts for upper-middle class households over time if AMT relief is not extended.

CBO's effective tax rate study shows that with the AMT allowed to deepen its reach into the income distribution, by 2010, *and under current law*, the effect of the Bush tax cuts on the top quintile (top 20 percent) would be only a 1.3 percentage point decrease in the effective federal tax rate, compared with a 2.2 percentage point decrease which would hold without the AMT. In other words, by 2010 the AMT will take away nearly half of the tax cuts for the top 20 percent of households — and this will mainly affect the bottom half of this top quintile, *not* the very richest.

If the capital income tax cuts currently scheduled to expire before 2010 (such as tax cuts on dividends and capital gains) were made permanent, the effects of the AMT would be even more dramatic.

Some Republicans have suggested that the minimum tax is of little concern to the Bush Administration because it largely hits taxpayers in blue states (see "Bush to Blue States: Drop Dead?," Fortune Magazine, March 7, 2005). The fact that there was no response when Rep. Rangel raised the issue in 2001 also indicates lack of interest. (See letter to President, Appendix E). Grover Norquist was quoted in The San Diego Union - Tribune, on March 13, 2005 as saying, "Why in the world would we cross the street to solve the Democrat's problem that they created – that primarily first screws their constituents and then everybody else."
Those Republicans ignore the fact that the minimum tax also disproportionately hits families with children.

The explosion in the scope of the alternative minimum tax has several major consequences:

- **Greater complexity**. Millions of Americans have to fill out two tax returns in order to compute their Federal income tax liability. The number of individuals facing this complexity is far greater than the number of individuals who actually pay the minimum tax. Millions of other taxpayers must file the minimum tax return even though they do not have liability. On average, it takes 6 hours and 2 minutes to complete the AMT form.

- **Shifts the burden to middle class**. The AMT will result in a shift of tax burden from upper-income taxpayers to the upper-middle class. The AMT marginal rates are higher for middle-income taxpayers than for the very wealthy. As a result of the expanding scope of the AMT, according to Tax Policy Center estimates, the percent of federal personal income taxes paid by individuals with annual incomes over $500,000 will *decline* (from 27.4% to 26.2%) by 2010. In contrast, the percent paid by the upper-middle class ($100,000 - $500,000) will increase (from 40.8% to 45.4%).

  The AMT will no longer be a tax paid exclusively by the richest. By 2010, households with incomes between $75,000 and $100,000 will be 18 percent more likely (and households with incomes between $100,000 and $200,000 more than twice as likely) to be on the AMT than those with incomes exceeding $1 million.

- **Large mortgage on future budgets**. Even a modest reform of the AMT would be extremely costly if the recent tax cuts were made permanent. According to CBO's most recent budget report, permanently extending the current higher AMT exemption (to keep the number of AMT households roughly constant) would cost nearly $800 billion over ten years with interest costs included.

- **Virtually no minimum tax liability due to traditional tax preferences**. The minimum tax initially was enacted to ensure that individuals could not use tax preferences to avoid any liability. Virtually all of those tax preferences have been removed from the minimum tax. Now, virtually all AMT liability is due to three items that few people would consider to be tax preferences: the deduction for personal exemptions, the deduction for State and local taxes, and miscellaneous itemized deductions.

The Republicans have argued that the minimum tax problem is a result of Democratic tax legislation. The attached discussion of the history of the minimum tax makes it clear that it is Republican tax policy, not Democratic tax policy, that has caused this problem. (See Appendix F.)

V. More Losers than Winners from Estate Tax Repeal

> "Mr. (Warren) Buffet said repealing the estate tax 'would be a terrible mistake,' the equivalent of 'choosing the 2020 Olympic team by picking the eldest sons of the gold-medal winners in the 2000 Olympics.'"
>
> *"Dozens of Rich Americans Join in Fight to Retain the Estate Tax,"*
> *David Cay Johnston,*
> *New York Times, February 14, 2001*

President Bush's Fiscal Year 2006 budget rejects that advice. It recommends a permanent extension of the tax cuts (including estate tax repeal) that were enacted in 2001 and 2003. Making those tax cuts permanent also appears to be a priority of the Congressional Republicans.

However, not all of those tax cuts seem to have the same priority for the Congressional Republicans. Press reports have indicated that, at least in the House of Representatives, the

Republican Leadership intends first to pursue legislation making permanent the estate tax repeal, leaving the other tax reductions for later.

Under present law, the estate tax is repealed completely in 2010 only.

Pursuing permanent estate tax repeal legislation first is a reflection of the Republican priorities. When compared to the alternative of simply extending the law that is in effect in 2009, repeal will benefit an extraordinarily small number of estates. Also, repeal would disadvantage far more estates than would benefit from repeal.

Under current law, the basis of assets acquired from a decedent is stepped up to the value of the asset at death. Essentially, this step-up in basis eliminates all capital gains taxes on increases in the value of property occurring before death. For farms and small businesses, a step-up in basis is particularly valuable. Many gains in business assets are taxed at ordinary income rates, not the favorable capital gains rates. Step-up in basis occurs even if the estate has no liability for Federal estate taxes.

In calendar year 2009, under current law, there will be a $3.5 million estate tax exemption ($7 million for married couples utilizing simple estate tax planning). According to the Joint Committee on Taxation, only 7,500 estates nationwide (approximately three-tenths of one percent of all decedents) would have any estate tax liability in 2009 with that exemption. Everyone else would have very favorable tax treatment: no estate tax, and full step-up in basis.

The estate tax repeal that occurs in 2010 is accompanied by repeal of the current step-up in basis rules. The repeal legislation substitutes a carryover basis regime under which the heir generally would have the same tax basis as the decedent, remaining liable for tax on increases in value before death. The only exemption from a straight carryover basis regime would be a $1.3 million additional basis amount ($3 million for property transferred to a surviving spouse).

The carryover basis rules accompanying estate tax repeal would place burdensome compliance and reporting requirements on all estates with gross assets of over $1.3 million. The Joint Committee on Taxation estimates that at least 71,400 estates would be subject to the new compliance and reporting requirements. All of those 71,400 estates would face compliance and reporting burdens far greater than those imposed under the current estate tax. ***The number of estates facing those burdens would be more than nine times the number that would benefit from estate tax repeal.***

This is not the first time that Congress enacted carryover basis rules. Carryover basis rules were enacted by the Congress in 1976, delayed in 1978, and repealed retroactively in 1980. That repeal occurred after Congressional hearings where the practical problems with carryover basis were discussed in great detail. Testimony indicated that the carryover basis was particularly problematic for farms and other small businesses; its application was virtually impossible in many cases. Even executors testified that they were surprised with the extent of the problems faced by estates with only marketable securities, the basis of which was not available in many cases.

Many of those 71,400 estates will not only face compliance burdens, but they actually will face tax increases by reason of repeal. Official and private studies indicate that many estates have significant levels of unrealized appreciation, often greater than 50%. Those studies also indicate that farms and other small businesses are far more likely to have unrealized appreciation than other estates. For estates with significant unrealized appreciation, the potential tax increases from carryover basis can exceed the savings from estate tax repeal for a wide range of estate sizes –

- Estates with no debt would face tax increases if the size of the estate was between $2.6 million and $4 million.

- Estates with significant debt (20 percent of assets) would face tax increases if the size of the estate was between $2.6 million and $5 million.

Carryover basis would be particularly disadvantageous to estates holding farms, other small businesses, or rental real estate because those estates quite often have large, unrealized gains. The basis of their assets will have been reduced by depreciation adjustments, creating unrealized gains even where the value of the property has not increased. Businesses like farms typically have large amounts of ordinary income assets with low basis. Also, those estates are likely to have significant levels of debt so that their unrealized gains as a percentage of their net assets could be quite large.

Farm estates would be among those most likely to be adversely effected by carryover basis. Like other small businesses, they have large unrealized gains and significant levels of debt. In addition, farm estates are eligible for special benefits under the current estate tax rules. They are entitled to special valuation rules that can reduce the value of the estate by a maximum of $840,000. They are also eligible for benefits for land subject to conservation easements.

As a result, the Department of Agriculture has estimated that only approximately 300 farm estates nationwide would have estate tax liability in 2009, approximately 1 percent of all farm estates of decedents in 2009.

The Department of Agriculture figures indicate that more farm estates would have liability under the new carryover basis rules than would have estate tax liability under current law. The Department of Agriculture numbers make it clear that there will be more losers than winners in the farm sector from estate tax repeal. Farm estates utilizing the current law benefits with significant debt levels would face potential tax increases if the size of the estate is between $2.6 million and $5.7 million.

For the overwhelming percentage of estates (in excess of 99 percent), a simple extension of the law in effect during 2009 would be the optimal result. They would continue to enjoy full step-up in basis, and have neither estate tax liability nor any compliance burdens.