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ESTATE TAX REPEALED

Effective January 1, 2010, the estate tax is repealed. Effective January 1, 2011 the estate tax is automatically restored. The top marginal estate tax rate will be 55 percent. The individual exemption amount will be \$1 million of assets.

To understand the implications of the repeal and the operation of the exemption when there is an estate tax, two terms must be understood – “stepped-up” basis and “carryover” basis. Basis generally means a taxpayer’s investment in property, with certain adjustments required after acquisition. In the case of many long-time family businesses, the basis of the business as an asset is modest or negligible, since many started literally from scratch.

Under the estate tax system in place through 2009 (and which will be restored in 2011) the heirs received the assets of the deceased taxpayer at a stepped-up basis. The basis of property passing from a decedent’s estate generally is the fair market value on the date of the decedent’s death (or, if the alternate valuation date is elected, the earlier of six months after the decedent’s death or the date the property is sold or distributed by the estate. The

advantage of stepped-up basis is, if the assets are later sold, any tax (most often a capital gains tax, but could be income tax depending on the nature of the asset) due is only on the appreciation in the assets since the heirs received the property from the estate.

A carryover basis means the heirs hold the assets at their original value or cost. Thus, any later sale would generate a tax, most often a capital gains tax, on the entire appreciation in the value of the assets.

If a taxpayer dies in 2010, the heirs will receive the assets under a modified carryover basis system. Under these rules, each decedent’s estate generally is permitted to increase the basis of assets transferred by \$1.3 million. The \$1.3 million amount is increased by the amount of unused capital losses, net operating losses, and certain “built-in” losses of the decedent. In addition, the basis of property transferred to a surviving spouse may be increased by an additional \$3 million. Thus, the basis of property transferred to a surviving spouse may be increased by at least \$4.3 million. The remainder of the assets would be received by the heirs with their original basis.

SBLC member, the Small Business Council of America (SBCA), has created an example describing the impact of the repeal versus an estate tax with a \$3.5 million exemption, which was in place in 2009.

“Assume there is a small business owner who has \$3.5 million of assets and no surviving spouse.

“Under total repeal: \$1.3 million of the assets receive a step-up in basis to the fair market value of those assets at date of death. The remaining \$2.2 million of assets will have the basis that the decedent had in those assets.

“As an aside, imagine if the decedent were an 85 year old man who acquired many of these assets more than 40 years ago... how anyone is even going to be able to figure out the carry over basis of those assets is beyond us. The burden is on the heirs to prove any basis, and many will fail to have enough records, resulting in a zero basis.

“Now when the heirs of this decedent sell this \$2.2 million of assets, they will be subject to tax on the difference between the then fair market value of the assets and any

basis they can prove the decedent had in those assets. For example, let's assume that the heirs are able to prove that the carry-over basis in the assets is \$1 million - then the heirs will be taxed on \$1.2 million (assuming the fair market value of the assets was still \$2.2 million).

“With a \$3.5 million exemption: All \$3.5 million of assets receive a step-up in basis to the \$3.5 million level (this is the fair market value of his assets as of his passing). Now when the heirs sell any of these assets (assuming the fair market value of the assets was still \$3.5 million), there would be no income tax and no estate tax.

“Thus, a single person with assets greater than \$1.3 million up to \$3.5 million is better off under the estate law as it stood in 2009 and is in a worse tax position under repeal of the estate tax. Similarly, a decedent who is married with assets greater than \$4.3 million up to \$7 million does better under the law as it stood in 2009 than he/she would under total repeal.”

I guess I would add the heirs are probably worse off in 2011 and beyond. They will receive the assets with a stepped-up basis but only \$1 million of the assets would be exempt from the estate tax, and top marginal estate tax rate will be 55 percent.

RETROACTIVE EXTENSION

Effective January 1, 2010, there is no Research and Development Credit. It, and another three dozen or so credits and deductions, have expired. However, there is a strong likelihood some or all will still be extended through December 31, 2010. The House passed H.R. 4213, which would do just that, before it left town for the year. The Senate did not consider the bill. But...

Senate Finance Committee Chairman Max Baucus (D-MT) and Ranking Member Charles Grassley (R-IA) sent a letter to Senate Majority Leader Harry Reid (D-NV) and Minority Leader Mitch McConnell (R-KY) before the Senate went home stating, “We write to inform you that early in the next year, we intend to address the extension of various tax provisions expiring on or before December 31, 2009. We intend to extend the provisions without a gap in coverage, just as the House did on December 9th of this year. The legislation will extend several important tax benefits to individuals and businesses.”

There is precedent for retroactive extension. The biggest fight will probably be over how to “pay” for the extension. The House used a provision requiring “carried interest” (this is how private equity and hedge funds are able to treat income as capital gains) to be treated as ordinary income as the revenue offset and the Senate does not like that option. The tax revenue necessary for the offset of the one-year extension is \$31 billion.

NEW YEAR

Phew, I think I set a new record for Weekly Reports.

I guess I should stop complaining about all the breaks Congress normally takes in a year. They did not take as many, and so neither did the Weekly.

It was a rough year for many small businesses and many of the associations that serve them. You have my heartfelt thanks for supporting SBLC's efforts in 2009. I am certainly hoping 2010 is a Happy New Year for us all. SBLC will be here for its member associations and their small business members. Thank you.