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Implications of Estate Tax Repeal

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Even as this article is being written, Congress is considering estate tax repeal. On April 5, 2001 the House passed H.R. 8, Death Tax Elimination Act of 2001. The Senate is also considering bills that would either change or repeal the estate tax. This issue of the NC State Economist explains the implications of the central element in the pending Death Tax Elimination Act of 2001 – the repeal of valuation rules allowing an updating (or "step-up") of an estate's basis.

Background

In 1999 the Federal Treasury collected $28 billion in estate and gift tax revenues. This is approximately 1.5 percent of the total federal revenue. Although not a large percentage, it is still a sum to be taken seriously. In comparison to estate tax revenues, gasoline taxes generated $39 billion, corporate income taxes accounted for $185 billion and income taxes produced $879 billion (Gale & Slemrod).

The federal budget topped $1.86 trillion for fiscal 1999/2000. Under previous legislation, any changes to revenue streams must be *budget neutral*. Budget neutral means that when a tax is repealed, the revenue must be generated elsewhere. Consequently if estate taxes are ultimately repealed, there must be $28 billion of new revenue collected to remain budget neutral. Although it is assumed that the cap on the step-up of assets in H.R. 8 would generate more revenue through increased capital gains tax revenues, there is no specific provision to compensate for any potential shortfall.

Who pays estate tax? Less than 2 percent of all estates pay estate tax. Under present law, a taxable estate is one with assets in excess of $675,000. Households in the top 20 percent of the income distribution in the United States pay 99 percent of all estate tax (Gale & Slemrod). According to IRS figures, 6.8 percent of taxable estates in the U.S. in 1999 reported farm assets as part of the estate; likewise 6.7 percent of taxable estates listed non-corporate businesses. Table 1 illustrates the size of asset holdings in taxable estates.

Table 1. Selected Characteristics of Taxable Estate Tax Returns Filed in 1999
(All dollar amounts in millions)

Farm Assets	Non-corporate Businesses	Stock	Cash & Cash Mgmt. Funds	Corp. Bonds	Mutual Funds	Other	Total
$373 (0.3%)	$590 (0.5%)	$47,130 (39.5%)	$13,383 (11.2%)	$1,509 (1.3%)	$910 (0.8%)	$55,281 (46.4%)	$119,176 (100%)

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Step-up in Basis

Under present law, assets an individual owns at death are *stepped-up* to fair market value on the date of death. Business property as well as personally held assets receive this treatment. It is this new value for assets held by the decedent that comprises the gross estate of the decedent. And it is this stepped-up value upon which estate taxes are levied. (There are certain provisions that allow for alternate valuation of assets under the Internal Revenue Code [IRC], but this article will not deal with those issues.)

Currently, every estate, regardless of size, enjoys the benefit of having assets stepped up to fair market value. This makes record keeping simple. An inventory is taken and, if necessary, appraisals are made to determine and assign fair market value to assets. Beneficiaries of estates then receive their inheritance or bequest with the new stepped-up value as the cost basis of assets received.

Individuals should keep a record of the inherited value for future reference should it be decided to sell or dispose of these assets. Frequently failure to maintain basis records of inherited assets leads to payment of greater capital gains taxes when they are sold. For example, timber is an asset that does not always have a record of stepped-up basis when tracts are inherited. Years later when the timber is marketable and sold, larger capital gains are often incurred without a record of increased basis.

Implications of the Repeal of Stepped-up Basis

The Death Tax Elimination Act of 2001 repeals the step-up in basis rules with two exceptions. The first allows for all estates to step-up $1.3 million of aggregate basis of selected assets. The second exception allows for aggregate basis of inherited assets to the surviving spouse to be stepped up by an additional $3 million. However, if a surviving spouse does not take advantage of the step-up benefit and lives on for years, then the heirs of the surviving spouse will receive assets with a carry-over basis. Property that a decedent received as a gift in the three years prior to death is not eligible for step-up in basis.

Almost 98 percent of estates will not experience a change relative to gross estate valuation and step-up in basis. Assets totaling $4.3 million may enjoy step-up in basis to fair-market value. Although executors will continue to have the same responsibilities as before, they will, in addition, need to create and maintain records for beneficiaries. These records will be necessary for proof of basis for any future sale of inherited assets.

However, for assets in excess of $4.3 million, step-up in basis will no longer be available. Beneficiaries will inherit assets with the *carry-over* basis of the decedent. In other words, the basis of assets above $4.3 million is not stepped-up to fair market value causing *built-in* capital gains in those assets.

For the 98 percent of estates that will continue to enjoy full step-up in basis of assets, records of that step-up should be maintained and delivered to beneficiaries for their use. In the farming community, depending upon date of death, assets might include land, buildings, machinery, equipment, breeding livestock, market livestock, grain held for sale or feed, growing crops, Christmas trees, timber, etc. Each category would have a fair-market value on the date of death of the decedent and would be included in the gross estate.

Upon transfer to a beneficiary, this new value begins as the cost-basis of the asset and a new long-term holding period also starts. Capital goods such as equipment, for example, if continued in trade or business by the beneficiary, are eligible to be depreciated with the stepped-

up value as cost-basis, and the deceased's date of death as the date the asset was placed in service. Large items are usually listed, and records are kept for business purposes. However, seemingly less important items such as grain and growing crops are often unaccounted for. These are frequently overlooked as well as estates are being settled. For these reasons, record keeping is crucial while estates are being administered. For both small and large estates, there exists the need to keep records on property that is held by the family for several generations. Land is typically such an asset in North Carolina.

Should the Death Tax Elimination Act of 2001 become law, new record keeping requirements will be necessary for estates with gross values above $4.3 million (assuming a surviving spouse). If the deceased, the executor and the beneficiaries do not keep sufficient documentation, the IRS will assume zero basis of assets. These record-keeping requisites will be mandatory for the decedent prior to death as well as the executor after death. Since assets above $4.3 million will not receive step-up in basis to fair market value, executors will need to make selection of those assets that will and those that won't. The executor will need access to all records of the deceased to determine what is the carry-over basis, so that accurate accounts are transferred to the beneficiary. One thing to keep in mind is that time plays a factor on both sides of death relative to the necessity of keeping accurate records.

Individuals accumulate assets over the course of a productive life. If enacted, an obligation will exist to maintain detailed records of cost basis of accumulated assets prior to death. Furthermore, H.R. 8 creates an additional burden on executors to maintain all carry-over records and make decisions as to which assets are included in the $4.3 million (and hence receive a step-up in basis) and which assets exceed $4.3 million in value.

Assets that exceed the $4.3 million and have carry-over basis will be taxed if and when the beneficiary sells them. Generally, these assets are capital assets and are taxable at capital gains rates; currently 20 percent is the maximum rate. This taxation is part of the budget neutral requirement of any tax change.

For estate tax returns filed in 1999, the IRS reported a total of 103,993 filed in the United States. During the same period, 2,517 returns were filed from North Carolina. Also in 1999, the IRS reported there were 4,744 taxable gross estates in the United States with assets above 4.3 million dollars assuming equal distribution between 2.5 and 5 million gross estate value. The total gross value of these estates is valued to be $57.4 billion. Assuming further that each estate was able to pass $4.3 million with stepped-up basis to heirs, $37 billion would be subject to taxation at 20% capital gains rates. Therefore, if sold, these assets would generate $7.4 billion in tax revenues, a decrease of nearly $21 billion below what was collected in 1999 as estate tax. In order for annual budget neutrality to be maintained, an additional $21 billion would have to be raised from some other source. The question is where that revenue would come from.

Summary

If the Death Tax Elimination Act of 2001 is enacted, nothing will change for 98 percent of estates. For estates exceeding $4.3 million in gross value, additional record-keeping requirements before and after death will become mandatory for increased accuracy and completeness. This creates a long-lasting burden for those who inherit, bequeath or administer estates. Furthermore, the potential for nearly a $21 billion shortfall in revenues indicates a need for additional or new revenue sources that may affect the nation's broader population. Even though the act's removal of step-up in basis causes lasting difficulties for only a small percentage of the population (those with estates over $4.3 million), H.R. 8 will ultimately impact the entire population by creating the

need to generate additional revenue to offset the $21 billion shortfall.

Sources

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