ISSUE BRIEF

STEP-UP IN BASIS, CAPITAL GAINS, AND THE ECONOMY

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EXECUTIVE SUMMARY

Increasing taxes on the wealthy has been at the center of the Biden Administration's economic plan from the get-go. Among progressive policymakers and economists this is seen not only as a source of revenue to finance the Administration's social and economic priorities, but also as another policy lever to decrease growing wealth/income inequality. However, a proposed change to the tax treatment of appreciated assets when transferred to heirs in the event of death could impact Americans beyond the targeted wealthy and, coupled with higher capital gains taxes, could have unintended consequences for the American economy.

Current tax rules allow the adjustment of the value of an asset from its original cost to fair market value when the original owner dies and the asset is transferred to their heirs. Through this provision, the heir is only responsible for the capital gains taxes on the appreciation accumulated during their ownership. The current Administration proposes to change this long-standing provision by "ending the practice of "stepping-up" the basis for gains in excess of $1 million ($2.5 million for couples when combined with existing real estate exemptions) and making sure the gains are taxed if the property is not donated to charity."[1] But, past efforts to repeal the step-up in basis as well as recent economic studies point to difficulties with administering such system, as well as negative economic impacts that go beyond wealthy individuals.

- **Economic Impacts:** There are multiple channels through which increased taxation on capital from repeal of the step-up in basis will impact the economy. And these impacts could be amplified if capital gains tax rates are increased in conjunction with repeal of step-up in basis:
    - Due to increased financial strains caused by higher tax liabilities, existing businesses may be forced to downsize or close.
    - Additional taxes increase the cost of capital by increasing required earnings to cover the taxes and still offer a competitive return for investors. Increased capital costs and lower savings could discourage investment and prevent the opening of new businesses.
    - Increased capital costs are passed on to consumers in the form of higher consumer prices.
    - As private investment decreases, research and development (R&D) spending goes down.
    - Lower R&D spending and lower private investment could ultimately lower overall labor productivity. This reduces wages, economic growth, and living standards.

[1] The White House, "Fact Sheet: The American Families Plan," April 28, 2021. *https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/*

Two recent studies show a range of negative impacts on employment, investment, wages, R&D spending and overall gross domestic product depending on whether or not capital gains taxes are altered with the repeal of so step-up in basis.

- **Tax Compliance and Administration Problems:** Prior attempts to repeal or significantly change how the capital gains are taxed when transferred to heirs have failed of have been quickly repealed due to compliance and administration problems, such as:

  - *Issues with Determining the Tax Base and Value:* Under current law, the estate tax liability is based on the fair market value of bequeathed assets, leaving the original investment and appreciation largely out of the calculation. With the repeal of step-up in basis, proper documentation of the original investment and improvements as well as current value are required for an accurate calculation of appreciation over the lifetime of the assets, even if they have been owned for decades. This could introduce significant tax compliance costs.

  - *Carve Outs Result in More Complications for an Already Complicated Tax Code:* Many proponents of repealing step-up in basis, proposes carve-outs to diffuse the negative impacts of such repeal on family-owned businesses. But as mentioned by former Senator Max Baucus (D-MT) in a recent Wall Street Journal opinion piece, prior efforts to provide carve-outs and relief were unsuccessful, due to the exceptions being too narrow.

  - *More Carve Outs Provide More Opportunities to Game the System:* As the tax code becomes more complicated with special carve-outs, it also creates more opportunities for tax avoidance strategies. Repealing step-up in basis could further fuel such behavior, especially among the wealthy targeted by the repeal, who have access to tax planning experts.

  - *Problems with Tax Administration and Additional Cost:* Introducing an additional layer of complication to capital gains and estate tax calculations through repeal of step-up in basis will mean additional administrative and enforcement costs for the IRS, which is already facing an increased workload with funding that has changed very little over the years.

Potential tax increases on capital, such as a repeal of step-up in basis or higher capital gains tax rates, could have unintended consequences for the much-needed investment and economic growth the Administration aims for.

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INTRODUCTION

Increasing taxes on the wealthy has been at the center of the Biden Administration's economic plan since his inauguration. Among progressive policymakers and economists this is seen not only as a source of revenue to finance the Administration's social and economic priorities, but also as another policy lever to decrease growing wealth/income inequality. The Administration's intention to significantly ramp up the taxation of capital is clearly stated in The American Families Plan, and lower taxes on capital gains and dividends are seen as "loopholes" that reward "wealth over work."[1] However, a proposed change to the tax treatment of appreciated assets when transferred to heirs in the event of a death could impact Americans beyond the targeted wealthy and, coupled with higher capital gains taxes, could have unintended consequences for the American economy.

Current tax rules allow the adjustment of the value of an asset from its original cost to fair market value when the original owner dies, and the asset is transferred to their heirs. Through this provision, the heir is only responsible for capital gains taxes on the appreciation accumulated during their ownership, but not during the decedent's ownership. In the tax jargon, this is known as a "step-up" in basis. Estate taxes are also due as outlined by the law. Despite various attempts to change it in the past, the step-up provision has been part of the U.S. tax code since the Revenue Act of 1921.

The current Administration proposes to change this long-standing provision by "ending the practice of "stepping-up" the basis for gains in excess of $1 million ($2.5 million for couples when combined with existing real estate exemptions) and making sure the gains are taxed if the property is not donated to charity."[2] Knowing the potential adverse impact of such a proposal beyond wealthy households, especially for family-owned businesses and farms, the White House fact sheet states that "the reform will be designed with protections so that family-owned businesses and farms will not have to pay taxes when given to heirs who continue to run the business."[3]

The importance of the step-up provision for family-owned businesses and farms was also emphasized during discussions about the $3.5 trillion budget reconciliation. Even though Senate democrats plan to include the repeal of the step-up in basis in their reconciliation bill, they have significantly larger carve outs: the tax will apply to gains in excess of $5 million per person or $10 million per couple, with another $500,000 per couple allowed for homes that are primary residences. Largely seen as a messaging point, there is also a $25 million exemption for family farms.[4] The Ways and Means Committee, on the other hand, chose to keep step-up in basis but reduce the exemption for the estate tax, ultimately increasing taxes, albeit using a different approach.[5]

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1 The White House, "Fact Sheet: The American Families Plan," April 28, 2021. *https://www.whitehouse.gov/briefing-room/statements-releases/2021/04/28/fact-sheet-the-american-families-plan/*

2 Ibid.

3 Ibid.

4 Laura Weiss and Paul M. Krawzak , "Senate Democrats' tax options include big farm gains exemption," Roll Call, September 3 2021, *https://www.rollcall.com/2021/09/03/senate-democrats-tax-options-include-big-farm-gains-exemption/*

5 House Committee on Ways and Means, "Responsibly Funding Our Priorities," September 13, 2021.

Given the increased noise around the taxation of capital gains and the step-up in basis provision, this issue brief discusses past proposals and proposed changes in step-up of basis, how step-up interacts with the estate tax in terms of tax liability, the potential economic impact of such a policy change on the U.S. economy based on recent research papers, and other issues that impact tax compliance and administration that are still valid today.

PAST PROPOSALS: WHAT HAPPENED AND WHAT WERE THE MAJOR OBJECTIONS BESIDES ECONOMIC IMPACTS?

Repealing step-up in basis has been tried in the past for similar reasons and was unsuccessful due to various compliance and administrative issues that are still relevant today.

Past Proposals to Repeal Step-Up in Basis:

Under current law, capital gains are taxable when an appreciated asset is sold and bequeathing an appreciated asset[6] is not treated as a sale, "therefore there is no realization of built-in gain upon the gift or bequest of an appreciated asset." As mentioned before, a taxpayer who receives an appreciated asset from a decedent, would take the fair market value of the asset at the time of decedent's death as the cost basis and calculate his or her future gains using this stepped-up basis. For example, John Doe started a business with a $1 million investment and when he died the fair market value of the business was $10 million. Even though, the business appreciated by $9 million, his daughter, Jane Doe who inherited the business will consider the $10 million current value as her cost basis and if she sells the business later, only appreciation above the cost of $10 million during her ownership will trigger a capital gains tax obligation. There have previously been proposals to repeal the step-up in basis at death. These proposals generally took two forms:[7]

- Capital gains tax, calculated as the fair market value of the asset at the time of death less the decedent's basis, is triggered by the death and is immediately due when the asset is transferred to the heir. In our example above, the estate would be required to pay capital gains taxes on the $9 million appreciation when the asset is transferred to heir (assuming no carve outs or exclusions) and then Jane Doe can assume fair market value for future capital gains calculations. If she sells the business for $15 million at a later date, she will pay capital gains on the $5 million gain accrued during her ownership.

- The capital gains tax will be triggered by the sale of the asset by the heir. However, the tax calculation will be based on carryover basis with no step-up in basis. In the above example, Jane Doe will not pay any capital gains tax when she inherits the business, but if she later sells it for $15 million, she will pay taxes on the $14 million appreciation accrued during both John Doe's and her ownership.

Both approaches ultimately tax the $14 million appreciation of the business, but with different timing. There have been three prior legislative proposals that would have repealed the step-up in basis, but none were ever implemented:[8]

- The Tax Reform Act of 1976 would have imposed the carryover basis as described above but the provision was retroactively repealed in 1980.

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[6] Joint Committee on Taxation, "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System," March 16 2015. *https://www.jct.gov/publications/2015/jcx-52-15/*

[7] EY, "Repealing Step-Up of Basis on Inherited Assets: Macroeconomic Impacts and Effects on Illustrative Family Businesses," April 2021, *https://www.fb.org/files/FBETC_Stepped-Up_Basis_Report_2021*

[8] Tax Policy Center Briefing Book, "Key Elements of U.S. Tax System," May 2020, https://www.taxpolicycenter.org/briefing-book/what-difference-between-carryover-basis-and-step-basis

- The Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the estate tax and curtailed step-up in basis to $1.3 million, with any additional unrealized gains carried over for only calendar year 2010. In December 2010, Congress again retroactively reinstated the estate tax and step-up in basis rules for 2010.

- In 2015, the Obama Administration proposed repealing stepped-up basis, with a general exclusion of $100,000 gain recognized at death. The proposal was never enacted.

What Were the Objections Besides Economic Effects and Why are they Still Valid Today?

Over the years, multiple economic studies have highlighted the negative impact of repealing the step-up in basis on the cost of capital, investment, economic activity, and ultimately on the health of overall economy. This issue brief discusses the economic impacts and recent research in the later sections. But there are a number of other problems associated with repealing the step-up in basis, such as those related to tax compliance and administration. These are:

- *Tax compliance problems - Determining the Tax Base and Value:* Repealing step-up in basis introduces one more difficulty to estate tax planning. Under current law, the fair market value of bequeathed assets is factored in, leaving the original investment and appreciation largely out of the calculation, especially for smaller estates. For some estates, even the calculation of fair market value may be problematic if the assets are not actively traded on a market. With the repeal of the provision, proper documentation of the original investment and current value are required for an accurate calculation of appreciation over the lifetime of the assets, even if they have been owned for decades. This could introduce significant tax compliance costs. According to many, the repeal of the prior enacted legislations was partly due to the difficulty in determining an accurate basis for inherited assets.[9] Despite technological improvements, with ever evolving and intricate investment vehicles the issue remains largely the same today. In fact, according to some accounting experts, repealing step-up in basis, "is a tax record-keeping nightmare."[10]

  Although exemptions could be built into the new system to avoid some valuation difficulties, proponents of the repeal of step-up in basis argue that "significant exceptions would weaken the revenue and efficiency benefits of deemed realization."[11] There are also questions regarding the workability of the rules when there are exceptions or carve-outs for certain taxpayers.

- *Carve Outs - More Complications for an Already Complicated Tax Code:* Many proponents of repealing step-up in basis, proposes carve-outs to diffuse political objections as well as the negative impacts of such a repeal on family-owned businesses. Prior legislations had carve-outs for politically sensitive players. But as mentioned by former Senator Max Baucus (D-MT) in a recent Wall Street Journal opinion piece, prior efforts to provide carve-outs and relief were unsuccessful: "Congress tried that in 1997 for inherited family-held businesses but the exceptions were too narrow to benefit anyone and widening them would have been tantamount to repealing the estate tax altogether."[12]

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[9] Nonna A. Noto, "Step-Up vs. Carryover Basis for Capital Gains: Implications for Estate Tax Repeal," April 20, 2001, Congressional Research Service. *https://www.everycrsreport.com/files/20010420_RL30875_87433a3582adc3a8ec4a7b2896e27f9f519ebb78.pdf*

[10] Taylor Tepper, "Stepped Up Basis Reform: Biden's Middle-Class Tax Hike?" May 7, 2021, Forbes Advisor. *https://www.forbes.com/advisor/investing/stepped-up-basis-biden-tax-plan/*

[11] Richard Schmalbeck, Jay A. Soled & Kathleen DeLaney Thomas, "Advocating a Carryover Tax Basis Regime," 2017, Notre Dame Law Review, pg. 151. *https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=6675&context=faculty_scholarship*

[12] Max Baucus, "A Tax Plan to Destroy Farms and Ranches," September 1, 2021, the Wall Street Journal, *https://www.wsj.com/articles/tax-destroy-family-farms-ranches-small-business-step-up-in-basis-11630524254*

As the tax code becomes more complicated with special carve-outs, it also creates more opportunities for tax avoidance strategies."

Complexities were one of the main reasons for the ultimate repeal of the 1976 revisions that introduced carryover basis. According to Michael Graetz, "The complexities and technical difficulties that haunted the carryover-basis provision from the outset prompted a delay in its effective date in 1978 and ultimately were a major cause of its demise in the Crude Oil Windfall Profit Tax Act of 1980"[13]

Another potential problem could be for individuals/businesses who are looking into marginal investments to grow their businesses, the existence of a carve out in the form of a cap on tax free gains might prevent additional investment if the amount might trigger the tax liability. All these depend on the behavioral response of the taxpayer.

- *More Carve Outs* – More Opportunities to Game the System: As the tax code becomes more complicated with special carve-outs, it also creates more opportunities for tax avoidance strategies. Recent news articles have described how "many wealthy Americans deploy complex, arcane but wholly legal strategies to minimize their tax obligations."[14] According to Lawrence Summers and Natasha Sarin, these include "questionable appraisals; valuation discounts for illiquidity and lack of control; establishment of trusts that enable division of assets among family members with substantial founder control; planning devices that give some income to charity while keeping the remainder for the donor and her beneficiaries; tax-advantaged lending schemes; and other complex devices known only to sophisticated investors."[15] Repealing step-up in basis could further fuel such behavior, especially among the wealthy targeted by the repeal, who have access to tax planning experts. As a result, the proposed repeal is not likely to generate as much revenue as expected.

- *Problems with Tax Administration:* The Internal Revenue Service (IRS) has faced an increased workload with funding that has changed very little over the years. According to recent research, this means that the Agency cannot carry out its core functions efficiently and effectively and this has led to increasing taxpayer discontent, in addition to a significant tax gap.[16] Introducing an additional layer of complication to capital gains and estate tax calculations through repeal of step-up in basis will mean additional administrative and enforcement costs for the Agency.

[13] Michael Graetz, "To Praise the Estate Tax, Not To Bury It," 1983, The Yale Law Journal, pg.261. *https://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=2630&context=fss_papers*

[14] Kate Dore, "Many wealthy Americans escape big income tax bills. Here's how they do it," June 10, 2021. CNBC. *https://www.cnbc.com/2021/06/10/how-wealthy-americans-like-bezos-buffett-musk-pay-little-in-income-taxes.html*

[15] Lawrence Summers and Natasha Sarin, "A 'wealth tax' presents a revenue estimation puzzle," April 4, 2019, Washington Post. *https://www.washingtonpost.com/opinions/2019/04/04/wealth-tax-presents-revenue-estimation-puzzle/*

[16] Pinar Cebi Wilber, "Internal Revenue Service: Increasing Workload under Strained Budgets," May 2021, ACCF. *https://accf.ftlbcdn.net/wp-content/uploads/2021/05/ACCF_IRS_Report_051221V3.pdf*

PROPOSALS BY THE BIDEN ADMINISTRATION AND SENATE DEMOCRATS: HOW ABOUT THE CAPITAL GAINS TAX RATE?

The Biden Administration's proposal would repeal step up in basis for gains in excess of $1 million with death becoming a recognition event for the capital gains tax. However, the Administration goes one step further: The taxes on capital increases not only by repealing the step-up in basis but also taxing capital gains at higher income tax rates for households making more than $1 million. Specifically, The American Families Plan outlines an increase in the top income tax rate to 39.6 percent from 37 percent and applying this rate rather than the 20 percent long term capital gains tax rate for gains realized by high-income individuals. There is also a 3.8 percent net investment income tax, that would pull the new top capital gains rate to 43.4 percent. Going back to the example above, John Doe's estate which does not owe any capital gains taxes under current tax rules, would be subject to a $3.47 million capital gains tax bill under the proposal with a top rate of 43.4%. If the top rate does not change, there is still a hefty ($1.9 million) capital gains tax bill with repeal of step-up in basis. (See **Table 1**: **Part A** for calculations under both rate).

Senate Democrats are also floating the idea of repealing the step-up in basis albeit with much more generous exemption amounts: The tax will apply to gains in excess of $5 million per person or $10 million per couple, with another $500,000 per couple allowed for homes that are primary residences. Despite resistance by some House democrats,[17] Senate democrats are also expected to propose taxing the capital gains at higher income tax rates, aligning with American Families Plan.[18] If we use the same John and Jane

TABLE 1. Proposals to Repeal of Step-up in Basis under different Long-term Capital Gains Tax Rates

PART A: American Families Plan		
	Current Capital Gains Tax Rate:* 23.80%	**Increased Capital Gains Tax Rate:* 43.40%**
Fair Market Value at Death	$10,000,000	$10,000,000
Original Investment	$1,000,000	$1,000,000
Appreciation at Death	$9,000,000	$9,000,000
Exemption	$1,000,000	$1,000,000
Capital Gains Subject to Tax	$8,000,000	$8,000,000
Capital Gains Tax Due	$1,904,000	$3,472,000
Part B: Senate Democrats Plan		
	Current Capital Gains Tax Rate:* 23.80%	**Increased Capital Gains Tax Rate:* 43.40%**
Fair Market Value at Death	$10,000,000	$10,000,000
Original Investment	$1,000,000	$1,000,000
Appreciation at Death	$9,000,000	$9,000,000
Exemption	$5,000,000	$5,000,000
Capital Gains Subject to Tax	$4,000,000	$4,000,000
Capital Gains Tax Due	$952,000	$1,736,000
* Capital gains tax rates include net investment income tax of 3.8%		

https://webuiltthisbusiness.org/impacts/

[17] PwC, "House approves budget resolution, action to come on reconciliation tax bill," August 2021, *https://www.pwc.com/us/en/services/tax/library/pwc-house-approves-budget-resolution.html*

[18] Laura Weiss and Paul M. Krawzak , "Senate Democrats' tax options include big farm gains exemption," Roll Call, September 3 2021, *https://www.rollcall.com/2021/09/03/senate-democrats-tax-options-include-big-farm-gains-exemption/*

Doe example and using current and higher capital gains tax rates, the estate's capital gains tax obligation still increases significantly from zero under current tax law to almost $1 million with a 23.8% tax rate and $1.7 million with a tax rate of 43.4%. (See **Table 1: Part B** for calculations).

Interaction with Estate Taxes: What Happens to Total Tax Liability

For over 100 years the U.S. has relied on the federal estate tax, first for funding and later to prevent the concentration of wealth.[19] The estate tax laws have changed significantly over the years, most recently due to the Tax Cuts and Jobs Act of 2017. In 2021, the top statutory estate tax rate is 40% (with rates range from 18% to 40 %) with exclusions of $11.7 million per person ($23.4 million per couple) which are indexed for inflation going forward. Under current law, the estate of John Doe will not pay any tax since the fair market value of the estate is less than the exemption amount.

As stated in a recent paper by Robert Gordon, David Joulfaian, and James Poterba, "The effective tax burden on the returns from long-term investments held by many high net-worth households in the United States is determined in significant part by the interaction between the income tax treatment of capital gains and the estate tax, in particular the tax provision that allows basis step-up for assets that are passed to beneficiaries at death."[20]

In order to show the interaction between repeal of step-up in basis and the estate tax, as well as overall tax liability, assume that the business set up by John Doe, has a current market value of $20 million (with the same initial investment of $1 million). Under current law, Mr. Doe's estate has no capital gains tax bill but has an estate tax obligation of $3.3 million after accounting for the $11.7 million exclusion (See Table 2 for current law calculations). With the changes under The American Families Plan, while Mr. Doe's capital gains tax bill will increase, there will be a decrease in estate tax. The overall tax burden in this example will increase. For example, with a 23.8 percent capital gains tax rate, the estate pays $4.3 million on the capital gain and $1.6 million in estate tax, increasing the total tax bill to $5.9 million (an increase of approximately 77 percent). If, in addition to repeal of step-up in basis, the long-term capital gains tax rate is also increased, the estate will face a capital gains tax bill of $7.8 million and an estate tax bill of $195,000, bringing the overall tax liability to $8 million (an increase of 141 percent). (See **Table 2, Part A** for calculations.)

Due to the larger exclusions under the Senate Democrats' plan, the increase in the overall tax bill is less than under the Administration's plan. With a 23.8 percent capital gains tax rate, Mr. Doe's overall tax liability would be $5.3 million ($3.3 million for capital gains taxes and $2 million for estate taxes), an increase of 60 percent compared to current law. With a 43.4 percent rate, the total tax liability increases almost by 110 percent, from $3.3 million to $6.9 million. (See **Table 2, Part B**).

Under all these scenarios, the net value of the estate that the heir receives decreases significantly. In addition, these numbers could underestimate the total tax bill since 17 states plus DC have a state-level inheritance/estate tax. Table 3 provides details on the current proposals by the White House, the House Committee on Ways and Means, and the Senate Democrats.

Even though many progressive policymakers and groups see this as a tax on wealthy, the impact could be felt well beyond the wealthy and could damage an already fragile economy, that is trying to recover from the negative impact of the COVID pandemic."

[19] Darien B. Jacobson, Brian G. Raub, and Barry W. Johnson, "The Estate Tax: Ninety Years and Counting," *https://www.irs.gov/pub/irs-soi/ninetyestate.pdf*

[20] Robert Gordon, David Joulfaian, and James Poterba, "Revenue and Incentive Effects of Basis Step-Up at Death: Lessons from the 2010 "Voluntary" Estate Tax Regime," March 2016, NBER, pg 1 *https://www.nber.org/system/files/working_papers/w22090/w22090.pdf*

WHY DO WE CARE? ECONOMIC IMPACT OF CHANGING CAPITAL TAXES

As shown in the examples above, repealing step-up in basis could significantly increase the tax liability of estates, especially if they are consisting of family businesses or farms. Furthermore, if the majority of the assets are in illiquid form (such as business assets), with little cash available, it could push heirs to make uneconomical decisions, such as selling the business or borrowing money to pay the taxes. Increasing the debt load or using liquid assets to pay the tax obligation can also jeopardize the future of the inherited business by decreasing the assets available to reinvest and grow the business. This may explain the resistance against the repeal of step-up in basis, especially by small business owners, including family-owned multigenerational farms.[21]

Table 2. Proposals to Repeal Step-Up in Basis and Increase Capital Gains Tax Rates: How about Estate Taxes?

PART A: American Families Plan			
	Current Law Current Capital Gains Tax Rate:* 23.80%	**Repeal Step-up in Basis Current Capital Gains Tax Rate:* 23.80%**	**Repeal Step-up in Basis Increased Capital Gains Tax Rate:* 43.40%**
Fair Market Value at Death	$20,000,000	$20,000,000	$20,000,000
Original Investment	$1,000,000	$1,000,000	$1,000,000
Appreciation at Death	$19,000,000	$19,000,000	$19,000,000
Exemption		$1,000,000	$1,000,000
Capital Gains Subject to Tax	$0	$18,000,000	$18,000,000
Capital Gains Tax Due	$0	$4,284,000	$7,812,000
	Estate Tax: 40%	**Estate Tax: 40%**	**Estate Tax: 40%**
Taxable Estate	$20,000,000	$15,716,000	$12,188,000
Estate Tax Exemption (2021)	$11,700,000	$11,700,000	$11,700,000
Taxable Amount	$8,300,000	$4,016,000	$488,000
Estate Tax Due	$3,320,000	$1,606,400	$195,200
Total Taxes Paid	$3,320,000	$5,890,400	$8,007,200
Part B: Senate Democrats Plan			
	Current Law* 23.80%	**Current Capital Gains Tax Rate:* 23.80%**	**Increased Capital Gains Tax Rate:* 43.40%**
Fair Market Value at Death	$20,000,000	$20,000,000	$20,000,000
Original Investment	$1,000,000	$1,000,000	$1,000,000
Appreciation at Death	$19,000,000	$19,000,000	$19,000,000
Exemption		$5,000,000	$5,000,000
Capital Gains Subject to Tax	$0	$14,000,000	$14,000,000
Capital Gains Tax Due	$0	$3,332,000	$6,076,000
	Estate Tax 40%	Estate Tax: 40%	Estate Tax: 40%
Taxable Estate	$20,000,000	$16,668,000.00	$13,924,000.00
Estate Tax Exemption	$11,700,000	$11,700,000	$11,700,000
Taxable Amount	$8,300,000	$4,968,000	$2,224,000
Estate Tax Due	$3,320,000	$1,987,200	$889,600
Total Taxes Paid	$3,320,000	$5,319,200	$6,965,600
* Capital gains tax rates include net investment income tax of 3.8%			

[21] The groups that oppose the repeal of step-up provision largely represent small and family-owned businesses such as the American Farm Bureau Federation, the Associated General Contractors of America and National Federation of Independent Business (NFIB). For a full list of supporters, see *https://www.portman.senate.gov/index.php/newsroom/press-releases/portman-entire-senate-republican-caucus-urges-biden-administration-drop*

Table 3. Current Plans Impacting Tax Obligation for Estates			
	White House Plan	**House Ways & Means Plan**	**Senate Plan**
Step-Up in Basis	Repealed for gains in excess of $1 million	Retained	Repealed for gains in excess of $5 million ($10 million per couple)
Exemptions or relief provided for:	family-owned businesses, farms		$25 million exemption for family farms
Capital Gains Tax			
Top rate	39.6%	25.0%	39.6%
Net investment income tax	3.8%	3.8%	3.8%
Surtax*		3.0%	
Combined	43.4%	31.8%	43.4%
Estate Tax			
Top rate	40.0%	40.0%	40.0%
Exemptions**	$11,700,000	$6,020,000	$11,700,000
*Only applies to modified adjusted gross income in excess of $5 million. **The exemption amount is for 2021, except the Ways & Means plan which applies to 2022.			

Even though many progressive policymakers and groups see this as a tax on wealthy, the impact could be felt well beyond the wealthy and could damage an already fragile economy, that is trying to recover from the negative impact of the COVID pandemic.

Higher Capital Taxes: Less Investment and Less Economic Growth

Increased capital taxation through repeal of step-up in basis not only hurts the inherited businesses subject to these taxes, but also has negative consequences for the overall economy. A 2015 Joint Taxation of Committee (JCT) report highlights this connection: "If small businesses are sold, there may be a shift toward less overall investment in small business. If small business owners borrow funds to pay the estate tax, they may reduce their investment in the businesses, and this reduced investment could have deleterious effects on the larger economy."[22]

There are multiple channels through which an increase in capital taxation, whether it is repeal of step-up in basis or an increase in the capital gains tax rate, can impact the macro economy. Specific impacts are outlined and described in a new study by Regional Economic Modelling, Inc. (REMI):[23]

- Due to increased financial strains caused by higher tax liabilities, existing businesses may be forced to downsize or close.
- Additional taxes in the form of repealing step-up in basis, increases the cost of capital by increasing required earnings to cover the taxes and still offer a competitive return for investors. Increased capital costs and lower savings, in turn, could discourage investment and prevent opening of new businesses.
- Increased capital costs are passed on to consumers in the form of higher consumer prices.

[22] JCT, 2015. Pg. 2

[23] *REMI, "The National Economic Impacts of Current Legislative Proposals to Change the Capital Gains Tax," July 2021. https://committeetounleashprosperity.com/wp-content/uploads/2021/07/The-National-Economic-Impacts-of-Current-Legislative-Proposals-to-Change-the-Capital-Gains-Tax.pdf*

The study also outlines other impacts resulting from the increased cost of capital and decreased private investment:

- As private investment decreases, closely associated research and development (R&D) spending goes down.
- Lower R&D spending and lower private investment could ultimately lower overall labor productivity. This reduces wages and ultimately economic growth and living standards.

The size of these impacts is obviously dependent on the tax rates and tax basis under consideration. However, the proposals coming out of the current administration and the Congress, point to significant tax increases throughout the economy, mainly targeting capital and jeopardizing the future of the U.S. economy.

Quantifying Economic Impact of Repealing Step-Up in Basis:

Two recent studies that quantified the macroeconomic impact of repeal of step-up in basis as described above, alone and in conjunction with higher capital gains tax rates. As shown above, increased capital gains tax rates will amplify the impact of repeal of step-up in basis on the economy. The first study, conducted by Ernst and Young,[24] considers just repeal of step-up in basis and finds:

- 80,000 fewer jobs in each of the first ten years
- 100,000 fewer jobs each year thereafter
- A $10 billion annual decrease in U.S. GDP ($100 billion over 10 years)
- Lower wages given that about 1/3 of the burden of the tax increase is shifted onto labor

The second study, conducted by REMI, goes one step further and considers the repeal of step-up in basis in conjunction with a higher top capital gains tax rate (43.4 percent).[25] As expected, the inclusion of the higher long term capital gains tax rates amplifies the economic burden:

- Sustained annual job losses ranging from over 500,000 to almost 1 million depending on how the government spends the tax revenues
- A $600 billion reduction in private investment and a $6 billion reduction in R&D spending over 10 years
- A loss of $1 trillion in GDP over 10 years.

Depending on what kind of policy changes the U.S. could face, these are sizeable impacts for a U.S. economy already suffering under the impact of the COVID pandemic. According to most recent private estimates, the U.S. economy is expected to grow slower than previous estimates due to the increased impact of Delta variant.[26] The on-going pandemic is expected to disrupt supply chains further and increase inflation for 2021.

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[24] E&Y, 2021.

[25] REMI, 2021. This study specifically analyses Sensible Taxation and Equity Promotion Act (STEP).

[26] Katia Dmitrieva and Bloomberg, "Goldman Sachs Predicts Slower U.S. Growth in 2021 due to Delta Variant," August 18, 2021. Fortune. *https://fortune.com/2021/08/18/goldman-sachs-us-growth-forecast-cut-delta/*

"These small businesses suffered disproportionately during the pandemic: 34 percent were forced to shut down their doors, according to recent estimates.[27] As the studies above show, a further increase in tax burden due to repeal of step-up in basis could have additional negative impacts on the viability of these businesses, further slowing the potential growth of the U.S. economy.

Small businesses make up a large share of the U.S. economy: 99 percent of all businesses are considered small and they employ a little over 47 percent of the U.S. workforce. These small businesses suffered disproportionately during the pandemic: 34 percent were forced to shut down their doors, according to recent estimates.[27] As the studies above show, a further increase in tax burden due to repeal of step-up in basis could have additional negative impacts on the viability of these businesses, further slowing the potential growth of the U.S. economy.

CONCLUSION

The U.S. as well as world economic recovery is happening while uncertainty created by the COVID pandemic continues. Potential tax increases on capital, such as a repeal of step-up in basis or higher capital gains tax rates, could have unintended consequences for the much-needed investment and economic growth the Administration aims for. The impact on small and family-owned businesses could be disparate. Existing analysis shows that such tax increases will have negative impacts not only on investment, but also on productivity, wages, and employment. Repeal of step-up in basis could also exacerbate the use of tax avoidance strategies by the wealthy, decrease expected revenues, and increase tax compliance, administration and enforcement costs. Congress should take all these impacts into considerations before considering such legislation.

[27] Iman Gosh, "34% of America's small businesses are still closed due to COVID-19. Here's why it matters," May 5, 2021, World Economic Forum. *https://www.weforum.org/agenda/2021/05/america-united-states-covid-small-businesses-economics/*

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