OCTOBER 2020

NAHAD Issue Alert

Potential New Capital Taxes on Small Businesses under a President Biden

The 2017 Tax Cuts and Jobs Act cut taxes on small businesses, individuals, and corporations. Many small businesses were helped by the new 20% small businesses deduction, lower estate taxes, and better equipment expensing laws. The Biden/Harris campaign has proposed new taxes on businesses that could potentially increase the burden of taxation above and beyond simply increasing small business tax rates. Democrats in Congress and the Biden/Harris ticket have also proposed a number of capital taxes targeted at wealthy individuals with the potential to envelop many inventory heavy family owned businesses. Below is an outline of some of the proposals that small businesses are facing, including many NAHAD members, and are gearing up to fight against under a Biden/Harris Presidency.

Joe Biden's Death Tax Plan

Former Vice President Joe Biden would return to 2009 law for the death tax (A $3.5 million exemption and a 45% rate vs. a $11.7 exemption and 40% rate currently) without spousal portability and not indexed for inflation. According to the JCT, this would more than triple the number of taxpayers currently subject to the death tax. Joe Biden's other proposed tax increases would compound the financial and compliance burden on next generation family business owners.

Step Up in Basis Repeal

Former VP Biden has proposed repealing the step up in basis provision of the law. His tax plan clarifies that step up in basis will drop off after $1 million. As an example, consider a small distribution business, starting with almost zero basis that has grown to a $50 million distribution business with locations and jobs across several regions. If step up in basis were repealed, upon the sale of the business, the next generation of ownership would owe capital gains taxes on the full $50 million in appreciation throughout the lifetime of the business, instead of as current law calls for having the basis "stepped-up" to its current fair market value on the date of the previous owner's passing. Stepping up the basis of property protects next generation business owners from the potential double whammy of paying a 40% death tax and then another large capital gains tax upon the sale or future passing on of the business. Look for this issue to be very much in play over the next four years.

Capital Gains Due at Death

The death tax is not like other taxes that are tied to predictable events, for this reason it can be particularly hard for family businesses to deal with. Death is not predictable in the same way a planned sale is. When a business owner passes away, under the Biden's plan, inheritors would owe capital gains taxes as if a profitable sale of a business had occurred upon the owner's death. In addition to setting the next generation up for a massive capital gains liability upon the future sale of the business by repealing step-up, capital gains on the appreciation of the business is due from the estate upon the death of the business owner. This would add yet another layer of complexity to the tax code for family businesses at the worst time possible, after the death of a business owner.

Taxing Capital Gains as Ordinary Income

The potential tax increase of family businesses would be compounded by Joe Biden taxing capital gains as ordinary income. A part owner of a large family business making over $1 million in income would potentially have to pay the ordinary income tax rate on a small business they inherited at death versus the capital gains tax rate. Let's step back and consider an example with all of the above factors worked in.

<u>Example, Trump vs. Biden Tax Plans</u>

John is second generation part-owner of a family distribution company valued at $50 million, started by his father with little basis in the sixties. John receives a taxable income, between salary and profit from the business passing through to his taxes, of $1 million per year for running this profitable distribution business as his father is reaching his later years. The business provides blue-collar employees in warehouses and distribution centers with good pay and benefits.

Let's consider a scenario where John's father, the majority owner of this company, dies in 2021. John who has been running the family business for his father is set to inherit the company, with the goal of keeping it running and staving off a fire-sale to a publicly traded multi-national company that would let go of workers.

John's tax obligations under current law, post Trump tax cuts:

If John's father used the full 2021 estate tax exemption of $23.4 million, the combined $11.7 million exemption of him and his wife, about half of the business would be protected from death taxes. John while attempting to keep everyone employed and the business running would still need to come up with $10 million cash for death taxes (40% estate tax rate on roughly $25 million over current exemption). Upon paying this huge tax bill to Uncle Sam, John would inherit the distribution company and have the basis of the company "stepped-up" upon inheritance to its fair market value of $50 million. No additional capital gains or income taxes would be due by the estate or heir. In some states an additional state estate/inheritance tax may be due.

Assets left after taxes: Roughly $40 million

John's tax obligations after the potential Biden tax increases:

If Democrats sweep Congress and enact Joe Biden's death tax hike, ($3.5 million exemption and 45% rate, with no spousal portability), the tax burden on John who is hoping to preserve jobs and keep the family business running increases significantly. Under the Biden proposal, John must first pay capital gains taxes on the $50 million business. Capital gains for taxpayers making more than $1 million would be taxed as ordinary income rates, a proposed 39.6% under the Biden tax plan. Additionally, the 3.8% net investment income tax created by the Affordable Care Act still applies increasing the total tax rate to 43.4%. Since our hypothetical next generation business owner John makes $1 million from his partnership in the family business according to pass-through rules, his inheritance of the business is now taxed at his income tax rate.

Business value	$50 million
Capital gains tax rate	43.4%
Capital gains tax owed	$21.7 million

After paying the capital gains due at death, John must also pay the death tax on the remaining assets in the estate. Instead of coming up with $10 million, John must now pay Uncle Sam over $11 million in death taxes under the Biden tax plan.

Value of remaining estate	$28.3 million
Estate tax exemption	$3.5 million
Taxable estate	$24.8 million
Estate tax rate	45%
Death tax owed	$11.2 million

Altogether, the Biden tax hikes would shrink the $50 million business all the way down to $17.1 million versus $40 million under current law. That's not factoring in state transfer taxes.

Under Biden's tax plan fully implemented, John is having to shut down warehouses and branches, cutting blue collar jobs and explaining to families why the jobs they have held for decades are disappearing. The total change between the Trump and Biden tax plans for the future of John's thriving family business is over $20 million. For many businesses operating on small margins, coming up with any spare cash is a struggle.

That's a look at what's at stake for the treatment of small businesses under a possible Biden administration. NAHAD continues to work with our small business association allies to keep taxes low on family businesses.

NAHAD's Issue Alerts are written by Alex Ayers, Vice President, Public Policy with Schoening Strategies, LLC. Alex also serves as the Executive Director of the Family Business Coalition where he previously served for seven years as director of public policy. Alex has published papers and studies in various policy areas including taxes, energy, agriculture, and economics and has testified on tax policy.

For NAHAD's complete library of Issue Alerts, visit this page