VALUATION BRIEF

Estate Tax Uncertainty

Uncertainty over the ultimate fate of the federal estate tax has lingered since passage of President Bush's tax cuts in 2001. Under the current legislation, the estate tax is progressively reduced to zero by 2010 at which time the estate tax disappears—only to return the following year at the original 55% rate unless the Congress makes the estate tax repeal permanent. Following President Bush's re-election in 2004, the Republican controlled Congress sought aggressively to make the first-term tax cuts permanent. However, consideration of the issue has been waylaid in the current Congress as a result of concerns over the growing fiscal budget deficit due to mounting costs associated with the war in Iraq and hurricane relief following Hurricane Katrina. Fiscal conservatives have also made permanent repeal of the estate tax more tenuous, particularly as the ultimate cost of any repeal remains a highly debated issue. Government estimates indicate that repeal of the estate tax would cost $290 billion of ten years. Lobby groups opposing repeal of the estate tax estimate the cost in excess of $975 billion. The true cost is likely to lie somewhere between these estimates.

Uncertainty over the future of the estate tax issue has created additional problems for many states. Currently, the state level estate tax is coupled with the federal estate tax (47% rate). The federal government collects the tax then issues the state's respective portion to that state. In anticipation that the estate tax may be permanently repealed, seventeen states and the District of Columbia have introduced bills seeking to impose a new state level estate tax should the federal tax be abolished. These states have faced intense opposition to the bills. In fact, taxpayers appear set to successfully challenge the legality of the new state level estate tax legislation in Pennsylvania, New Jersey, and Washington (state), forcing reconsideration and reform of the legislation.

As a result of these developments at the federal and state levels, Republicans in the Congress appear willing to accept a compromise over the future of the estate tax. Following expiration of the current tax cuts, the compromise may set the federal estate tax at a 15-20% rate, similar to the capital gains rate. In the absence of an estate tax, heirs are faced with a capital gains tax on a carry-over basis. The capital gains tax liability is based on the increase in value from when the asset was acquired by the deceased and the time when the asset is sold by the heir. With an estate tax in place, the

HIGHLAND GLOBAL, LLC
A MEMBER OF THE AMERICAN BUSINESS APPRAISERS NATIONAL NETWORK
PO BOX 6895, MYRTLE BEACH, SC 29572 843.457.2546 T
1221 BRICKELL AVENUE, 9TH FL, MIAMI, FL 33131 > 305.347.5170 T > 305.374.6146 F
www.highlandglobal.com
www.businessval.com

capital gain is based on the increase in value from the date of death/when the heirs inherit the asset and when the heirs sell it (the stepped-up basis).

To see the impact of each situation, consider the case where John Doe dies with an estate valued at $20 million. The estate is comprised entirely of 1,000,000 shares in publicly-traded company XYZ Enterprises, Inc. which were acquired by John Doe in 1950 at $2.00 per share. At the time of his death, shares in XYZ Enterprises, Inc. were trading at $20. If there is no estate tax, the heirs' tax liability would be calculated as follows, assuming that the heirs sell the shares upon the death of John Doe[1]:

Calculation of Heirs' Tax Liability No Estate Tax Situation	
Shares	1,000,000
Cost Basis	$2,000,000
Value at time of Death	$20,000,000
Capital Gain	$18,000,000
Capital Gain Tax Rate	15%
Tax Liability	$2,700,000

However, if the estate tax were reinstated at the lower 15% rate, the tax liability could be slightly higher. This assumes that there is no exclusion as in the current estate tax schedule. Should the compromise include an exclusion schedule, the tax liability could be similar to or lower the tax liability under a no estate tax scenario.

Calculation of Heirs' Tax Liability Estate Tax Compromise	
Shares	1,000,000
Cost Basis	$2,000,000
Value at time of Death	$20,000,000
Exclusion	??
Taxable Value	$20,000,000
Tax Rate	15%
Tax Liability	$3,000,000

[1] These are simplistic examples used for illustrative purposes only. They are in no way intended to be construed as tax advice or estate planning advice.

HIGHLAND GLOBAL, LLC
A MEMBER OF THE AMERICAN BUSINESS APPRAISERS NATIONAL NETWORK
PO BOX 6895, MYRTLE BEACH, SC 29572 843.457.2546 T
1221 BRICKELL AVENUE, 9TH FL, MIAMI, FL 33131 > 305.347.5170 T > 305.374.6146 F
www.highlandglobal.com
www.businessval.com

In both scenarios, it is assumed that the heirs convert the shares into cash upon the death of Joe Doe to avoid any further capital gains tax liability.

As the preceding examples illustrate, there is only a marginal difference in the tax liability under the no estate tax scenario and the 15% compromise estate tax plan. If the estate tax were reduced to 15%, many wealthy individuals may forego extensive planning to avoid the taxation as the cost of such planning may not be significant compared to the potential savings. However, the future of the estate tax remains uncertain. Therefore, many wealthy individuals still believe that proper estate planning is an essential mechanism for protecting transgenerational wealth by seeking to minimize the tax liability of the heirs through the use of family limited partnerships, for example.

HIGHLAND GLOBAL, LLC
A MEMBER OF THE AMERICAN BUSINESS APPRAISERS NATIONAL NETWORK
PO BOX 6895, MYRTLE BEACH, SC 29572 843.457.2546 T
1221 BRICKELL AVENUE, 9TH FL, MIAMI, FL 33131 > 305.347.5170 T > 305.374.6146 F
www.highlandglobal.com
www.businessval.com