

One-Page Policy Brief



Capital Gains Tax vs. Estate Tax – Burden on Family Business Owners and Farmers

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It is sometimes claimed that the carry-over capital gains tax regime is worse for family business owners and farmers than the estate tax. This claim ignores several issues, such as the fact that capital gains will never force a family business or farm's sale.

The Law: The Economic Growth Tax Reduction and Reconciliation Act (EGTRRA) modified the treatment of capital gains tax for 2010, when the estate tax was temporarily repealed. For purposes of capital gains tax, assets are valued according to the “basis” at which they were purchased. If the asset is sold, taxes are due on the increase in value (capital gain) above the basis.ⁱ

Prior to 2010, the basis of an asset was “stepped-up” each generation so that increases in value during previous generations went untaxed. For instance, Harry buys property in 1990 at a value of \$10,000, which increases to \$60,000 in 2008. In 2008 Harry dies and leaves the property to his son, Jim. The bequeathed property's basis is “stepped-up” from \$10,000 to \$60,000, meaning Jim will owe no taxes on the \$50,000 gain. However, if Jim sells the property two years later when it increases to \$70,000, Jim will owe taxes on the gain of \$10,000 that occurred after Harry died.

In 2010, the law changed from step-up to carryover. The carryover law “carries” the original basis over from its original owner. Under carryover, if Harry leaves his son with property valued at \$60,000, Jim faces tax on all gain above the original basis of \$10,000.

The Issue: The carryover regime means that more capital gain could be subject to tax – if the asset is sold.ⁱⁱ Some pundits speculate that more people will want to sell appreciated assets and thereby incur capital gains taxes than would have been impacted by the estate tax. Even if this is true, there is no question as to whether estate tax repeal is better than step-up.

Key Difference: The estate tax is owed when assets are transferred from the decedent to the heir, regardless of whether there is a gain in value or whether the asset is sold.ⁱⁱⁱ Capital gains tax is owed if and only if the heir chooses to sell an inherited *and* appreciated asset. The estate tax forces the sale of family business assets when the asset's value exceeds cash-on-hand. Capital gains tax comes due only if the family chooses to sell their appreciated assets.

Furthermore, under current law the top capital gains tax rate is 25%,^{iv} whereas the estate tax rate is 35%. The estate tax rate of 35% applied to all bequeathed assets, whereas the 25% capital gains rate only applies to appreciated assets which are sold.

For family business owners and farmers, the capital gains tax is a major improvement over the estate tax.

Citations

ⁱ Internal Revenue Service, “Tax Topics: Topic 409, “Capital Gains and Losses,” <http://www.irs.gov/taxtopics/tc409.html>, March 4, 2010.

ⁱⁱ Internal Revenue Service, “Tax Topics: Topic 409, “Capital Gains and Losses,” <http://www.irs.gov/taxtopics/tc409.html>, March 4, 2010.

ⁱⁱⁱ Internal Revenue Service, “Estate Tax,” <http://www.irs.gov/businesses/small/article/0,,id=164871,00.html>, October 21, 2008.

^{iv} Internal Revenue Service, “10 Facts About Capital Gains and Losses,” <http://www.irs.gov/newsroom/article/0,,id=106799,00.html>, February 18, 2010.