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Small Business & Entrepreneurship Council

GEORGETOWN CAPITAL ADVISORS

SENSITIVITY ANALYSIS: STEP ACT OF 2021

August 2021

Background

In coordination with the Biden Administration, Senators Chris Van Hollen (D-MD), Corey Booker (D-NY), Bernie Sanders (D-VT), Elizabeth Warren (D-MA) and Sheldon Whitehouse (D-RI) have proposed repealing the 100 year-old step-up in basis rule, which has allowed generations of families and entrepreneurs to build businesses, family and privately-owned enterprises, farming and ranching operations, and other businesses to be efficiently and fairly passed on to subsequent generations without taxes levied on the appreciation of that business at the time of an owner's death on top of applicable federal and state estate and inheritance taxes.

Known as the STEP Act, this plan would impose sizable new tax liabilities would be imposed immediately upon death, forcing many family and privately-owned enterprises of all sizes to raise capital to settle these new tax liabilities. To ensure continued control over the business, it is likely that many families and beneficiaries would seek to borrow money against the assets to settle these unplanned-for tax debts, as the new and increased forced valuation of the taxable assets (land, buildings, equipment, intellectual property, etc.) under the STEP Act likely are not readily available in cash equivalents. New tax liabilities would also be applied retroactively under the STEP Act when assets are transferred via trusts or upon an owner's death to family members or other beneficiaries of a trust. The Act also treats non-grantor trust assets as being sold and therefore taxed every 21 years for living owners, creating a taxable event where one never existed before, and possibly forcing a full or partial liquidation to settle the tax debt.

This analysis looks at the estimated total value of assets economy-wide that would be subjected to taxation under the STEP Act, considers the costs and additional taxes this scenario would impose, and estimates the wealth transfer to banks from heirs and trust beneficiaries. The analysis was commissioned by the Small Business & Entrepreneurship Council and conducted by Georgetown Capital Advisors LLC.

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Key Findings

- **Winners**: Under the STEP Act, repealing the "step-up in basis" at death and taxing unrealized gains of trust assets every 21 years will likely force households with limited access to liquidity to take out significant loans to pay a portion of the new federal tax on inherited assets – primarily benefiting the Wall Street banks that will provide the loans and potentially netting them approximately $38 billion in income through interest payments and fees on borrowers over a 10-year period[1]
  – Many factors influence how a taxpayer chooses to pay their tax bill. Therefore, this analysis references the midpoint of the potential range of outcomes (i.e., 50% of tax bill borrowed at an estimated average interest rate of 4.75%)
- **Losers**: Households inheriting/holding $1+ million in unrealized capital gains that will be forced to liquidate family assets, take out loans, or both – adding another layer of uncertainty to an already uncertain future for closely-held family businesses

Income flows to Wall Street over 10-years after policy change (@ 43.4% capital gains rate; $bn)

% of Tax Bill Borrowed	Interest Rate on Borrowings: 3.75%	4.25%	4.75%	5.25%	5.75%
25%	$15	$17	$19	$21	$22
50%	$30	$34	$38	$41	$45
75%	$46	$51	$56	$62	$67
100%	$61	$68	$75	$82	$90

High-Level Methodology

- Data from the Federal Reserve Board 2019 Survey of Consumer Finances (SCF) and 2018 mortality rates from the CDC were used to estimate the initial amount of annual unrealized gains likely to be stepped-up at death, which are then assumed to grow by the CBO's projected growth rate for Nominal GDP; initial data suggests ~$72bn of unrealized gains would likely have been taxable for households if step-up were repealed (including proposed exemptions)
  – Analysis considers ~84% (~$60bn) of this amount to be from illiquid assets (e.g., closely-held businesses) and excludes the remaining ~16% (~$12bn) which is considered to be from liquid assets (e.g., stocks, mutual funds) that households would likely sell a portion of to pay the tax without having to borrow
  – Analysis includes estimated unrealized gains from trust assets, which are de minimis when compared to the amount of household unrealized gains (see page #3)
- A sensitivity analysis was conducted to estimate the impact of the tax policy changes on the amount of income that would flow to banks over 2022-2031 from taxpayers who fund all or a portion of the tax through borrowing under a range of interest rate assumptions by tracking through the effects of repealing step-up in basis/taxation on trust assets unrealized gains every 21 years and applying a capital gains tax rate of 43.4% *(Biden proposed 39.6% + 3.8% NIIT)* to the annual amount of unrealized gains that would become taxable upon death
- Assumed banks charge an initial fee of 2% on the annual total of new loans taken out by taxpayers to fund the tax and charge interest annually on existing loans; also assumed that taxpayers pay down 5% of their principal loan amount each year to reduce their interest expense over time (this is a conservative assumption as loans secured by collateral typically do not require payment towards the principal amount)
  – Despite taxpayers gradually paying off their debts, the cumulative amount of outstanding Wall Street loans grows each year as tax bills are incurred by new households upon the death of a loved one and/or business partner, and as trust assets are subject to unrealized gains tax beginning in 2026 – resulting in a new recurring revenue stream for Wall Street courtesy of the tax policy changes
  – Annual fees on new loans + interest payments on the cumulative amount of outstanding loans = Wall Street income (2022-2031)

[1] *The STEP Act offers taxpayers the option of deferring tax payment up to 15-years under a government payment plan, placing the government in direct competition with private lenders and could result in the government placing a lien against the subject property.*
Sources: Federal Reserve Board; Center for Disease Control and Prevention, Congressional Budget Office (Feb 2021); Morgan Stanley Smith Barney (Mar 2020).

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Source Data & Assumptions – Eliminating Step-Up in Basis at Death

Household Unrealized Gains Data

$ in Billions	[A] Total unrealized gains	[B] Mortality rate	[C]=A*B Annual unrealized gains likely to be stepped up at death	[D] Annual unrealized gains likely to be stepped up at death, adjusted for exemptions
All households	$30,500	0.5%	$155	$48
Table addendum				
Forbes 400	2,300	1.0%	24	23

Source: CDO Center for Statistics, Fed Board Survey of Consumer Finance, and Forbes 400

- Assumptions regarding annual gains tax reference the Federal Reserve's Survey of Consumer Finances data on total household unrealized gains [A] and mortality rates per the CDC [B] to determine annual amount of unrealized gains that would be taxable upon death [C]
- After proposed exemptions (i.e., $1MM per person, $250k gain on sale of principal residence), approx. $72bn of gains (all households + Forbes 400 estimate) [D] would be taxable per 2019 data
- Analysis only considers ~84% of this total (~$60bn) which excludes gains on liquid assets (e.g., stocks and mutual funds), and grows this number annually by the CBO's Nominal GDP growth rate projection

Other Assumptions

A. Data from Morgan Stanley on consumer margin loans[1] suggests individual households facing taxes on [D above] annually could borrow today at an average interest rate of ~4.75%
- Analysis shows a range +/- ~1% to account for margin of error and changes in future rates

B. Assumes households pay down 5% of their principal loan amount annually to reduce interest expense over time, which reduces the interest income flowing to banks in the analysis
- This is a conservative assumption as margin loans typically do not require payment towards the loan principal as the loan is secured by the value of the underlying assets (which the borrower will presumably sell a portion of in the future to repay the loan)

C. Assumes that many Americans would rather take out loans to pay the tax upfront rather than allow the government to place liens on their assets for the right to extend payment over 15 years; range of Tax Bill Borrowed assumes varying willingness to accept government liens on assets
- Also accounts for varying willingness to use/sell liquid assets (cash[2], stocks, bonds, etc.) to finance the tax bill; the S&P500 has averaged a 13.6% annual return the past 10 years and is expected to return 6.6% annually over the next 10 years[3] – suggesting households may prefer to borrow at a rate that is lower than the future expected return on their equity holdings

D. Assumes banks charge an initial fee of 2% for originating/providing the loans
- This is a conservative assumption as fees vary widely depending on financial institution and taxpayer circumstances; reducing fee to 0% only reduces cumulative income to banks by ~10%

Other Analysis Assumptions	Reference	Rate
Interest Rate Charged By Banks	[A]	3.75% – 5.75%
Annual Loan Repayment (% of Loan Principal)	[B]	5%
% of Tax Bill Borrowed	[C]	25% – 100%
Initial Bank Fee (% of Loan Principal)	[D]	2%

[1] Loan that is secured using one's assets as collateral, typically requires no fixed payments other than regularly scheduled interest.
[2] Among households with sufficient unrealized gains to be subject to tax, cash/checking/savings funds equate to <10% of total unrealized gains.
[3] Per Charles Schwab May 2021 estimates.

Source Data & Assumptions – Taxation of Unrealized Gains in Trusts

Trust Asset Data

A

Trust Assets $ in Billions	2004	2007	2010	2013	2016	2019
Total Trust Assets	**$1,002**	**$803**	**$724**	**$1,322**	**$1,178**	**$1,021**

Source: Survey of Consumer Finance; includes est. Forbes 400 (~2% of total)

A Assumptions regarding the amount of trust asset unrealized gains that will become taxable every 21 years (beginning in 2026) is based on Fed SCF data regarding the amount of trust assets over 3-year intervals[1]

– Data shows dramatic inflows and outflows overtime

B

Implied Trust Assets $ in Billions	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Total Trust Assets	**$1,002**	**$936**	**$869**	**$803**	**$776**	**$750**	**$724**	**$923**	**$1,122**	**$1,322**	**$1,274**	**$1,226**	**$1,178**	**$1,126**	**$1,073**	**$1,021**
Change		*(67)*	*(67)*	*(67)*	*(26)*	*(26)*	*(26)*	*199*	*199*	*199*	*(48)*	*(48)*	*(48)*	*(53)*	*(53)*	*(53)*

B To estimate the annual total trust assets for years where data was not available, the analysis assumes the observed change between 3-year periods occurs evenly throughout the period (i.e., decrease from 2004 to 2007 occurred evenly between the years)

C

2019 Total Trust Assets by Year Added to Trust $ in Billions	<2005	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	Total as of 2019
Current Trust Assets	$145	$20	$22	$24	$10	$3	$15	$127	$132	$142	$49	$51	$47	$66	$85	$81	**$1,021**

C By taking estimates for the annual balance of trust assets B and factoring in an estimated ratio of annual inflows/outflows, the analysis estimates the composition of the current trust assets (as of 2019) based on the year they were first placed within a trust

D

Future Taxable Unrealized Gains $ in Billions	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031
Balance of Trust Assets added 21 year Prior	--	--	--	--	$69	$8	$8	$3	$1	$3
(x) Estimated Unrealized Gains % of Balance	33.3%	33.3%	33.3%	33.3%	33.3%	33.3%	33.3%	33.3%	33.3%	33.3%
Taxable Unrealized Gains	**--**	**--**	**--**	**--**	**$23**	**$3**	**$3**	**$1**	**$0**	**$1**
(x) Portion Attributable to Non-Public Stocks	84.0%	84.0%	84.0%	84.0%	84.0%	84.0%	84.0%	84.0%	84.0%	84.0%
Taxable Gains on Illiquid Assets	**--**	**--**	**--**	**--**	**$19**	**$2**	**$2**	**$1**	**$0**	**$1**
(x) Capital Gains Tax Rate %	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%	43.4%
Annual Unrealized Gain Tax on Illiquid Assets	**--**	**--**	**--**	**--**	**$8**	**$1**	**$1**	**$0**	**$0**	**$0**

D After accounting for future outflows from trusts and asset appreciation (*at Nominal GDP*), we estimate what amount of trust assets will be taxable in future periods (*21 years after the assets were first placed into a trust*); by assuming 1/3rd of the asset values are attributable to unrealized gains (*based on SCF data*), and that households would likely could sell stocks to cover the tax related to those securities, we estimate **~$11 billion** of taxes on illiquid trust assets through 2031

– Of the total taxable gains that may generate income for banks in this analysis, gains on trust assets account for only 3% of the total as the majority of taxes will be attributable to the proposed household gains tax at death

[1] The STEP Act would exempt certain types of trusts, such as charitable trusts, qualified disability trusts, and cemetery trusts. Fed SCF data does not provide detail on type of trust. However, IRS trust income data by entity type from 2014 (most recent available) shows trusts that would be exempt under The Step Act generated only ~10% of all trust income that year.

Note: Periodic deemed sales every 21 years proposed only for non-grantor trusts, with grantor trusts taxed at grantor's death; assumes all trust assets subject to deemed sales given data limitations.

Note: Financing assumptions for trust asset unrealized gains taxes mirror those stated under the "Other Assumptions" section of page #2.