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The Effect of Estate Taxes on Family Business: Survey Results

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The Effect of Estate Taxes on Family Business: Survey Results

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A survey of 1,003 businesses examined the effect of estate taxes on family business behavior, including investment, employment, and strategic decisions. The results strongly suggest that estate taxes have marked effects on business behavior. These effects are more pronounced in larger firms where their potential impact is of a greater magnitude.

Introduction

As business journalist Sheila Poole (1995) wrote, "There's an old adage that you can't escape death and taxes, but unfortunately for some family businesses, the two go hand in hand." Estate taxes are a crucial issue facing our country, causing family-owned businesses to downsize and liquidate, and the problem may be getting worse.

Previous theoretical and econometric research suggests that estate taxes depress business growth and investment [Wagner (1993), Fleenor and Foster (1994)]. The effect upon family business may be particularly pronounced (Astrachan and Aronoff, 1995). Finally, as Bernheim (1987) argues, the indirect effects of estate taxes on personal income tax collections may offset the revenues generated by these transfer taxes.

The goal of this exploratory survey was to determine with greater specificity than ever before, and with the most reliable data available, the effects of estate taxes on business growth and survival, job creation, and capital investment. The survey was also designed to assess spending on estate tax planning and preparation as well as estate tax prefunding through the purchase of insurance.

Many business owners and those who work with family businesses have stated that estate taxes, particularly those on family business assets, are a serious threat to our national economy. They cite job loss, business failure, the forced sale of businesses, and a disincentive to invest as chief among their concerns. For example, the *MassMutual 1995 Family Business Survey* found that provisions for estate tax liabilities have caused 26% of family businesses to reduce capital investment. The *MassMutual 1994 Family Business Survey* found that 22% of business owners had made no provisions to pay estate taxes. The Arthur Andersen American Family Business Survey of 1995 found that 38% of business owners had little knowledge about the magnitude of their estate tax liability. The results of those surveys may not be dismissed as representative of only small businesses, because only those businesses with sales over $1 million were included in the samples.

The results of this survey suggest that estate taxes cause business owners to alter the management of their enterprises in ways that depress economic activity. They invest less and create fewer jobs than they would if they did not face the prospect of estate taxes. Those who have paid estate taxes on the assets of a prior generation report reduced employment and investment as a result. The results of this survey confirm the previous work reported by Astrachan and Aronoff (1995), who wrote, "The results strongly indicate that the modest revenue received from the tax is not worth its cost. The tax is apparently counterproductive, significantly limiting economic growth, development and job creation."

Methodology

The 1,003 businesses surveyed for this study were drawn from a list of approximately 40,000 family businesses in the United States. This list was constructed primarily from other sources (such as Dun & Bradstreet's *Million Dollar Directory*). Businesses were selected for inclusion in this list if they had sales in excess of a million dollars and at least two people of the same last name as officers or directors of the company. The general characteristics of the sample are listed in Table 1. Though a broader definition was employed, the data showed that nearly 80% of the sample fit a narrower definition of a family business: multiple generations of ownership, voting control, more than one family member in the business. With 81% of the businesses having been in the family for at least two generations and 38% reporting having had to pay estate taxes on a previous generation's assets, it is likely that most respondents have an accurate sense of the effect of estate taxes upon their businesses (see Table 2).

The survey was conducted as a telephone poll by the Gallup Organization between late July and early September of 1995. The survey instrument was designed by researchers from Kennesaw State University and Loyola University Chicago. The instrument was first tested on members from a trade organization and a small list of entrepreneurs, and then pretested by the Gallup Organization. The questions selected for the survey were based on the research team's collective experience working with family businesses as well as the pretest results.

Percentages reported in the survey have been computed on a valid-case basis that excludes minimal levels of nonresponse on an item-by-item basis. Responses were representative of the target population in terms of geography,

Table 1. Respondent Characteristics

Owners or co-owners of the business	100%
Owners considered the business to be a family business	95%
Business in family two or more generations	81%
Family owns 50% or more of stock of company	94%
(74% own 100% of the company)	
Greater than 50% of estate is tied in the business	68%
Median age of business owner	51 years old
Median business surveyed founding year	1953
Average prior five year sales growth	7-11%
Average sales	$94 million
Average employees	164
Average employees per family member employed	52

sales, and industry type, thus, observations were not weighted. To minimize the effects of extreme cases, the largest and smallest 1% of firms, in terms of sales, were truncated from the analysis. Thus, the analysis reported here was conducted on 983 cases.

When possible, to verify the consistency of the information received, the results of this study were compared with the results of two other prominent national studies of family businesses. These were the Arthur Andersen American Family Business Survey 1995 (Nager, Aronoff, and Ward, 1995) and *MassMutual's 1995 Family Business Survey* (Greenwald & Associates, 1995; Greenwald & Associates, 1994). In applicable cases, the results of this survey were consistent with those of the other surveys.

Results and Discussion

The results we report here are exploratory in nature. Because of the timeliness of this inquiry, preliminary results are reported in advance of a more complete analysis of the relationships among the data. To better understand the impact of estate taxes, we examined the results both in the aggregate and disaggregated by firm size. In the disaggregated analysis, we separated firms into three classes, based on owner-estimated market value of the business: less than $5 million, $5-$10 million, and greater than $10 million. Table 2 shows summary results for the aggregated sample.

In general, the results suggest that business owners believe that estate taxes exert a large influence on their current and future business decisions. More than half of respondents (61%) believe estate taxes will threaten their business's survival. Sixty-four percent believe that the prospect of estate taxes limit their business's growth. In addition, 60% believe they would hire more workers than previously planned if estate taxes were eliminated, while 68% say that

Table 2. Summary of Survey Results

Effect on Business Future	
Paying estate taxes will limit business growth	61%
Paying estate taxes will make business growth impossible	13%
Paying estate taxes will threaten business survival	64%
Paying estate taxes will make business survival impossible	8%
Paying estate taxes will require selling all or part of the business (Of these, 31% expect to be forced to sell or liquidate) (Of these 31%, 50% expect to eliminate 30 or more jobs and 20% expect all jobs will be lost)	33%
Effect on Current Business Behavior	
Estate taxes shorten the time owners will wait for an investment to pay off	36%
Willing to wait 4 or more years for investment pay off	58%
Estate tax liability reduces acceptable risk associated with business investment	68%
If estate taxes were eliminated would immediately hire workers (42% would hire 10 or more workers)	60%
If estate taxes were eliminated, revenues would grow an additional 5% or more	60%
Estate Planning and History	
Have basic will	92%
Estate planning beyond basic will	86%
Paid estate taxes on assets of a previous generation	38%
Have no knowledge of amount of estate tax liability	45%
Payment of estate taxes on the assets of a previous generation forced the business to shrink or restructure. (Of these, 42% paid those taxes within last 10 years)	37%
Time and Money Spent Planning for Estate Taxes (averages reported)	
Expenditure on attorneys	$16,113
Expenditure on accountants	$14,632
Expenditure on financial planners	$2,392
Total expenditure	$33,137
Time spent by family (in hours)	167

due to estate taxes, they are currently more risk-averse than they would otherwise be. Finally, business owners spend significant amounts of time and money in planning for and prefunding estate taxes. To the degree that these expenditures are viewed as a cost of conducting business, a reduction in estate taxes would release working capital that could be invested to generate further growth in the firm.

The second focus of our analysis examines whether the effects of estate taxes vary with the size of the business. As an indication of size, the approximate market value of the business, as reported by the business owner, was selected. This measure is used because it corresponds to the size of the estate tax that will be levied on the owner's estate.

Table 3. Summary of Disaggregated Survey Results

	Firm Size ($ Million)		
	< 5	*5-10*	*> 10*
Effect on Business Future			
Paying estate taxes will limit business growth	61%	67%	67%
Paying estate taxes will make business growth impossible	12%	17%	17%
Paying estate taxes will threaten business survival	64%	65%	72%
Paying estate taxes will make business survival impossible	6%	9%	11%
Paying estate taxes will require selling all or part of the business	36%	39%	41%
(Of the above, the percentage that expects to be forced to sell or liquidate all)	34%	24%	24%
Effect on Current Business Behavior			
Estate taxes shorten the time owners will wait for an investment to pay off	41%	37%	43%
Willing to wait 4 or more years for investment pay off	54%	60%	75%
Estate tax liability reduces acceptable risk associated with business investment	72%	74%	70%
If estate taxes were eliminated would immediately hire workers	58%	67%	67%
would hire 10 or more workers	18%	54%	56%
If estate taxes were eliminated, revenues would grow an additional 5% or more	56%	75%	64%
Estate Planning and History			
Have basic will	87%	97%	91%
Estate planning beyond basic will	83%	89%	86%
Paid estate taxes on assets of a previous generation	34%	38%	40%
Have no knowledge of amount of estate tax liability	50%	45%	31%
Payment of estate taxes on the assets of a previous generation forced the business to shrink or restructure.	34%	51%	42%
Time and Money Spent Planning for Estate Taxes (averages reported)			
Expenditure on attorneys	$6,817	$9,206	$34,986
Expenditure on accountants	$8,848	$11,245	$28,898
Expenditure on financial planners	$1,044	$1,858	$5,345
Total expenditure	$16,709	$22,309	$69,229
Time spent by family (in hours)	165	117	203

NOTE: Due to nonrepsonses to question on market value of business, percentages for disaggregated analysis will not average to percentages for aggregated analysis.

The results depicted in Table 3 show that business owners' behavior differs according to the size of the business. While the owners of firms with market values in excess of $10 million are the best informed, with 69% reporting who know their estate tax liability, they also appear to be the most adversely affected by estate taxes.

Overall, 33% of business owners reported that they expect to liquidate or sell all or part of their business. The sentiment is highest among the largest firms, where 41% share this concern. This expectation is supported by the historical experience of business owners. Of those owners who have paid estate taxes on the assets of a previous generation, 37% report that the business downsized. Again, the effect was greatest among larger businesses, where 42% report that the business downsized as a result of paying estate taxes on the assets of a previous generation.

Two questions of interest are those of the disincentive effect of estate taxes on the business owner's willingness to wait for an investment to pay off, and their willingness to accept risk. Since the payment of estate taxes may impose a high liquidity requirement on family businesses, we might expect the prospect of estate taxes to influence the willingness of these businesses to invest in projects that "tie up" capital for a long period. Further, while the economics literature is divergent on the effect of taxation on risk-taking, we might expect that the prospect of an estate tax liability would discourage a family business from investing in any project with a significant probability of loss. Such a posture may discourage businesses from investing in capital projects or supporting research and development which, if funded, would promote business growth. Therefore, we may expect that estate taxes could result in more conservative, and possibly myopic, investment behavior.

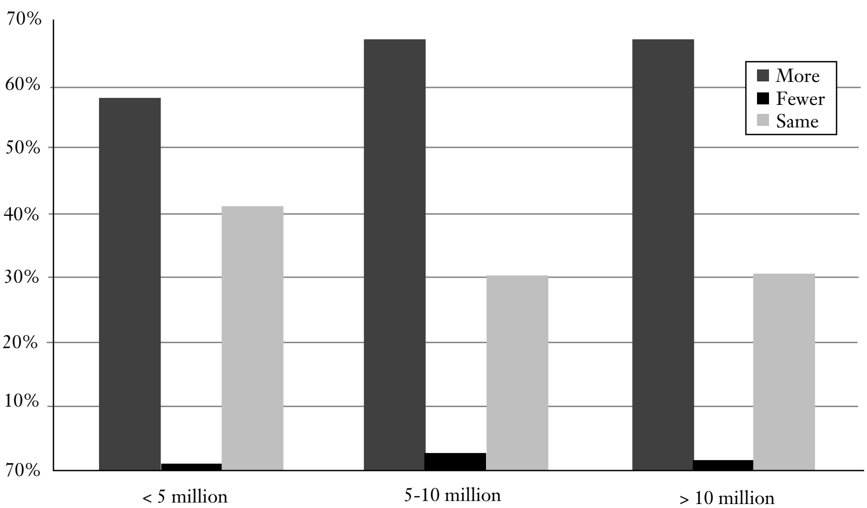
The survey showed that while family businesses invest for a long horizon, (the average family business is willing to wait over 4.6 years for an investment to pay for itself, with the largest firms being the slightly more patient—waiting over five years), 36% of family business owners report that the prospect of paying estate taxes makes them less willing to wait for an investment to pay for itself. This sentiment is strongest among businesses with values over $10 million, where 43% report that estate taxes shorten their investment horizon. This is of particular concern because these businesses employ the most workers and report the fastest growth.

Estate taxes also apparently reduce the incentive to accept the risks necessary for business growth. Faced with the tradeoff between risk and return associated with investing in new projects, 68% of businesses report that the prospect of estate taxes makes them less willing to accept the risk. This perception is consistent across all firm sizes. Accordingly, since larger firms are likely to have more capital to invest and thus greater potential for growth and job creation, that they, too, respond to the disincentive effects of estate taxes is a cause for concern.

One measure of the distortion caused by estate taxes is the additional growth that businesses expect would occur if estate tax were eliminated. Overall, the median firm expects that a repeal of estate taxes would induce them to invest in their businesses such that revenues would grow 5% faster than currently anticipated. Among the large firms, those with a market value over $10 million, revenue could be expected to grow 10% faster than otherwise anticipated. Indeed, even with estate taxes, family businesses with market values over $10 million report faster growth than their smaller counterparts. It is interesting to note that it is the largest businesses, those with market values over $10 million, who report the fastest revenue growth over the past few years. Thus it is the fastest growing businesses that expect to benefit the most from a reduction or repeal of estate taxes. One explanation is that due to their growth, these businesses are the most liquidity-constrained and thus would benefit most from a reduction in the cost associated with estate taxes. The conjecture is open for future research.

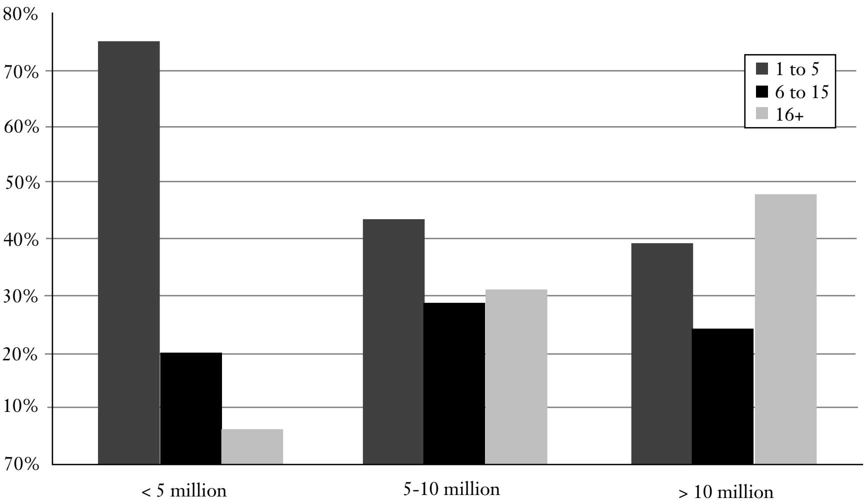
As with the investment decision, employment decisions are distorted by estate taxes. Overall, nearly 60% of business owners report that they would add more jobs over the coming year if estate taxes were eliminated. (See Figure 1.) The job creation potential is highest in firms with a market value over $5 million, where 67% report an expected increase in employment. Large firms would hire the most if estate taxes were eliminated. (See Figure 2.) Overall, businesses report that they would expect to hire nearly 19 additional employees if estate taxes were repealed. Since the average employment by firms in the survey was 164 employees, an increase of 19 employees represents a significant increase. Extrapolating over the population of family businesses with revenues greater than $1 million suggests that aggregate employment gains could be considerable.

Figure 1. If estate taxes were eliminated, would your firm hire more, fewer, or the same number of employees?



Firms with a market value below $5 million expect to add an average of seven employees. This figure rises to over 14 workers among firms with market values between $5 million and $10 million. The largest firms, those with values over $10 million, expect that elimination of estate taxes would allow them to expand their employment by over 30 additional workers per firm.

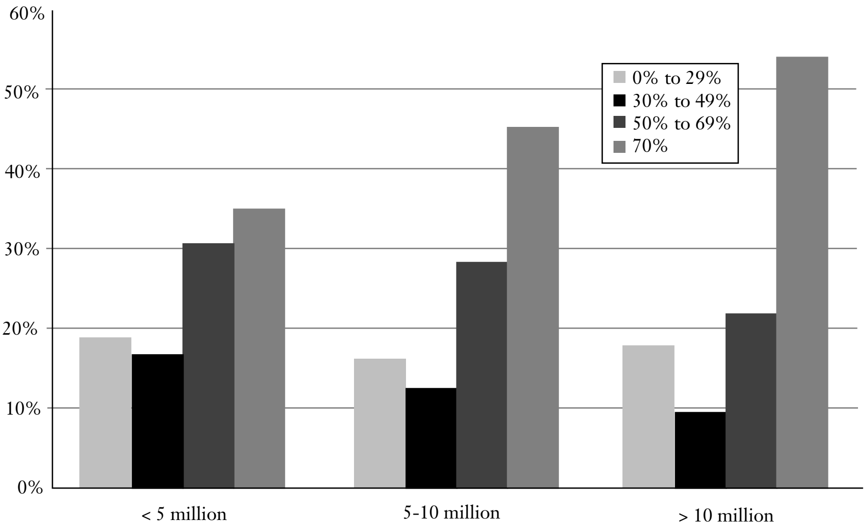
Figure 2. How many additional people would you employ over the next year?



Looking beyond the growth issues, we must question the effect of estate taxes on the business' ability to survive. Among owners of those businesses with a market value below $5 million, 36% report that estate taxes will make it significantly harder or impossible to survive. For the largest firms, those with market values over $10 million, 41% of business owners report that estate taxes will make it significantly harder or impossible to survive.

Conventional wisdom is that estate taxes should be less problematic for owners of larger businesses, because they are wealthier and therefore more likely to have financial assets set aside than are the owners of smaller businesses. The results of this survey do not support that expectation. Overall, 37% of family business owners report that their business accounts for over 70% of their estate. Among the largest businesses, those with a value in excess of $10 million, over 53% report that at least 70% of their estate is accounted for by the business' value. (See Figure 3.) What this might imply regarding the effect of estate taxes on a business' ability to survive and grow is that since these business owners are the most heavily invested in their business, they are less likely to have nonbusiness assets available for paying estate taxes. Thus, we would expect these businesses to report the largest potential for job loss and reduction in business growth due to estate taxes. And indeed, as discussed earlier, 42% (as compared with 37% for the entire sample) report that the business downsized as a result of paying estate taxes on the assets of a previous generation. This is also true for anticipated job loss due to estate taxes. The larger businesses report a median of 40 expected lost jobs and smaller business report a median of 25 expected lost jobs.

Figure 3. What percentage of your estate is represented by the value of the business?



In addition to the disincentive effect of estate taxes, there are significant costs associated with estate planning and the prefunding of estate tax liabilities. Family business owners reported average expenditures of over $33,000 on accountants, attorneys, and financial planners to work on estate planning issues. Since these responses were provided by a single owner or co-owner, they likely understate total expenditures by all family members. Beyond financial expenditures, estate planning frequently requires a significant commitment of family members' time. The average respondent estimated that family members spent over 167 hours on estate planning issues over the last six years. If estate taxes were eliminated, then expenditures of estate planning would most likely be reduced.

Frequently, family business owners prefund part of their expected estate tax liability through the purchase of insurance. Overall, 68% of family business owners report using this as an estate planning technique. Annual expenditures on insurance premiums vary across firm size, with owners of the largest firms paying the largest premiums. (See Figure 4.) Nearly 23% of the owners of firms valued over $10 million pay $50,000 or more in annual insurance premiums to cover their estate tax liabilities. In contrast, only 6% of busi-

Figure 4. How much do you spend annually on insurance premiums?

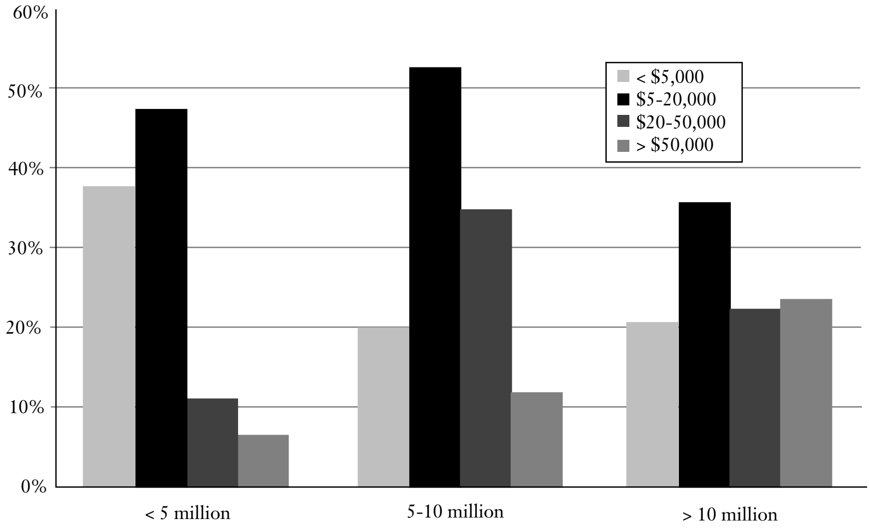
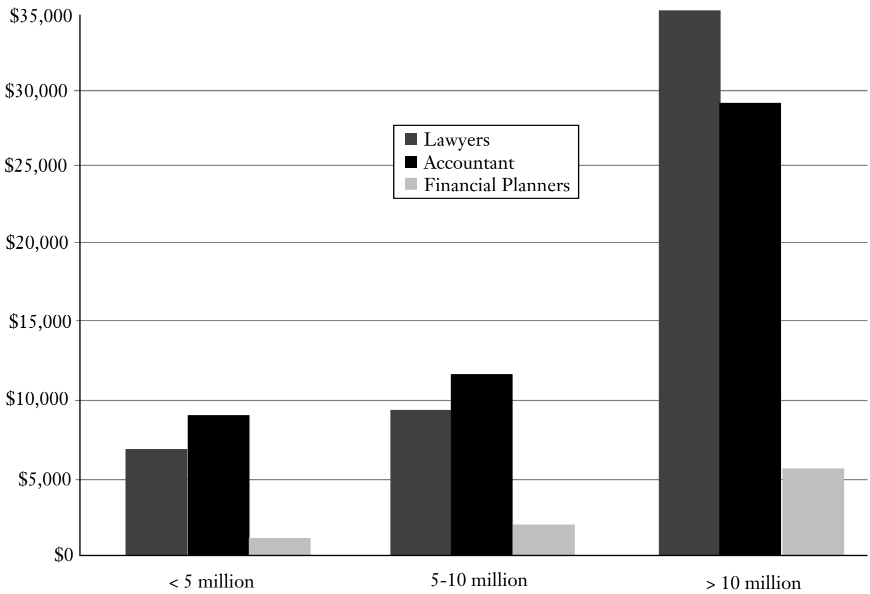


Figure 5. How much have you spent on lawyers, accountants, and financial planners?



nesses worth less than $5 million pay annual premiums of over $50,000. These premiums are not deductible expenses. They represent an additional drain on the firms' stock of working capital. In addition to insurance or other forms of prefunding estate taxes, there is the expense associated with estate planning—that of securing legal and financial counsel. (See Figure 5.) Overall, businesses averaged $33,137 in payments to lawyers, accountants, and financial planners. Firms valued in excess of $10 million average nearly $70,000 in these legal and financial expenses, representing yet another drain on capital.

An Agenda for Further Research

The data reported in this study is a first step in a research agenda of assessing the economic consequences of transfer taxes. The basic theoretical linkages between estate taxes and the growth of the firm are reasonably clear. The prospect of paying estate taxes discourages family businesses from investing in projects with long horizons or uncertain returns. Estate planning cost and insurance prefunding expenses drain capital which could otherwise be used to expand the firm. The analysis of a reduction or repeal of estate taxes would require a more explicit description of these relationships.

The important linkages for consideration are those between investment in the firm, revenue and employment growth, and the subsequent effect on corporate and income taxes. Specifically, the crucial linkages are (i) how much of a cost reduction is allocated to reinvestment in projects that grow the firm, (ii) how successful those investments are at producing additional revenue, and (iii) how that growth affects the firm's employment decisions. Information gathered in this and other surveys provide important steps in identifying the magnitudes of these effects.

Conclusion

Research such as that by Kotlikoff and Summers (1981) suggests that intergenerational transfers are the primary source of aggregate capital accumulation. However, estate taxes and their effect on the aggregate economy remains a relatively neglected area in terms of economic research. The information collected for this study suggests that the economic consequences of estate taxes on family business are significant. Data from this study suggest that estate taxes may distort the investment and employment decisions of family businesses in ways that slow growth. In particular, this survey suggests that the prospect of estate taxes encourages a myopic investment policy and discourages firms from investing in projects where entrepreneurial risks are present. Given the prominence of family businesses in the US economy, the disincentive effects of estate taxes are of great concern. Finally, expenses associated with estate planning and other compliance costs are an additional estate tax cost. Whether the revenues generated by estate taxes are worth the costs imposed on the economy is unclear. However, considerable evidence suggests a negative answer.

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