Testimony of

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Planning for the Death Tax: Can Small Businesses Survive?

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Chairman Walsh, Ranking Member Schrader, and members of the Subcommittee on Economic Growth, Tax and Capital Access, my name is Karen Madonia, and I am the Chief Financial Officer of Illco, Inc., a Chicago-area distributor of heating, ventilation, air-conditioning and refrigeration equipment, parts and supplies. Thank you for giving me the opportunity to talk about the estate tax and its effect on the many small family businesses which make up the United States economy. This is an issue that is very close to my heart as my family is in the midst of our own generational transfer.

Let me provide you with some background: Illco was a very small company with only seven employees when my father, John Glass, purchased it back in 1973. At that time, my dad was only 32 years old, with a wife, three daughters and a mortgage, but he knew he wanted something more than just a job. He wanted to use his passion to create something permanent, to be in control of his own destiny. With help from my grandfather, my dad decided to take a risk and go into business for himself. A community bank took my grandfather's assets, my dad's assets and a guarantee from a vendor as collateral for a $340,000 loan to purchase the company.

In those early years, my dad worked every job at Illco. During the day, he went to see customers and secure orders, then went back to the warehouse to pull and package them. The next day, he would make deliveries using my mom's station wagon before visiting more customers and taking more orders. Eventually, he was able to buy a truck and hire a driver, which left the station wagon free for my mom to pick up merchandise from Illco vendors while my sisters and I were at school. After the doors closed at 5:00, my dad would go to his office to perform both the accounts payable and accounts receivable functions. Every bit of profit he made got funneled back into the company so he could hire more people, buy more trucks and expand his inventory. My dad worked seven days a week, and most nights he did not get home until long after most people had finished their dinners. He had to give up any hobbies which took too much time away from his business, and our family vacations were mostly extended weekends because a week was simply too long for him to be away. Many weekends were spent entertaining customers, mostly over home-cooked meals, because that was the only way my parents could afford to wine and dine the people that were so necessary to the success of the business. But my dad's passion for the industry, his commitment to his employees, and his drive to grow his company empowered him to keep pushing even when interest rates hovered in the high teens during the late 1970's and early 1980's and things looked pretty ominous. Forty years later, he has a business with eight branches in three states, 92 employees and almost $40,000,000 in revenue.

My sisters and I grew up understanding that if we wanted to be successful at anything, we had to work hard and stay focused on our goals. We are all proud to work alongside our dad now, and look forward to making our own mark on the family business in the coming years. Hopefully, we have passed the strong work ethic that our parents displayed on to our own kids, who may decide to join us and carry the torch even further.

While I take great pride in my family's story, I realize that it is not really unique. There are thousands of families that have similar histories – families who have decided to put everything on the line to pursue the American dream. Like my dad, they want to create something that lasts, something that can be passed down to their kids, something that future generations can build upon to create their own legacies. While I am speaking today about my own family's experience, I know that all family business owners have the same issue: how do I pass this business on to future generations without losing some or all of it to the IRS in the form of estate taxes?

For the last few years, I have come to Washington with our trade association, HARDI, to talk to Members of the House and Senate about the issues that are important to our companies and our industry. Every year, estate tax is on the top of my list of topics to discuss. I personally find it fundamentally wrong to place a tax on death. If a person is able to accumulate wealth through hard work, and if that person pays his fair share of taxes on his income as it is earned, I do not understand how the government can justify taking a significant portion of what he has left simply because he opted to save and re-invest rather than consume. The United States has already benefited from that person's success because he has employed people who pay taxes, bought buildings on which he has paid property taxes and bought inventory and supplies from other companies, which can then afford to employ more people who pay taxes. He has created opportunity for the nation as a whole while creating prosperity for himself. We all benefit when a small businessperson succeeds. It seems counterintuitive to do anything to discourage the entrepreneurial spirit. To me, and probably to a large portion of the generation behind me, the estate tax serves as a tremendous disincentive. Why work harder than the next guy to build something big if it is likely to die when you do? Why not be just another worker, make just enough money to live comfortably, and not worry about generating any more wealth than that? Is this really the lesson we want to teach our young people?

I've heard the argument that we need to keep the estate tax so that we discourage family dynasties in the United States, and I've heard the argument that even though the estate tax was intended to be a temporary way to fund World War II, it now generates enough income for the Treasury that it will never eliminated. What I haven't heard from most lawmakers is that they understand the difficulty that imposing this tax presents to small businesses. In most cases, we're not talking about passing on bank accounts with multi-million dollar balances. We're talking about businesses where most of the net worth is tied up in inventory, accounts receivable, equipment and real estate. At Illco, for example, we carry an inventory valued at $10,000,000 and accounts receivable of about $5,000,000. Our inventory has to be high – we provide vital heating, air-conditioning and refrigeration parts and supplies to hospitals, schools, nursing homes and grocery stores. When the refrigeration system in a grocery store goes down, it needs to be repaired within hours or the food is lost. When the air conditioning system in a hospital doesn't work, patients cannot be appropriately cared for until air is circulating again. The parts and supplies that we sell must be on hand in order to facilitate quick repairs and replacements, which means that we must carry a heavy inventory. We also own five buildings and operate a fleet of twenty-two trucks, some of which cost upwards of $250,000. After paying our taxes and making our annual profit sharing contribution, the income that's left is put right back into the company so we can continue to carry an extensive inventory, extend payment terms to our customers and maintain our fleet and our buildings. If something happened to my dad and we were left with a large estate tax bill, we would literally have to sell parts of the company in order to pay it. That would likely mean shutting down branches, laying off workers or liquidating inventory just to be able to pay a tax bill that only occurred because an owner died. Even worse, our company might have to be sold outright, which would likely mean that instead of our employees being part of our small business family, they would become part of a larger company that likely would have no ties to the community. That certainly would not benefit them, and I would argue that it wouldn't benefit the economy as a whole either. America is depending on its small businesses to give wings to this recovery. Small businesses employ over half of the nation's private sector workforce and create the vast majority of new jobs. Especially in our current economy, government should be encouraging us to grow and prosper. Instead, Washington continues to force us to spend too much time and money focusing on things that have nothing to do with our businesses.

Over the last few years, my dad has spent countless hours and entirely too much money trying to navigate the estate planning waters. Instead of focusing on growing his business so he can open more branches and employ more people, he has had to strategize about how to pass his company on to his kids without having to dismantle it. And if that isn't enough of a challenge, he has had to do it with an ever-changing tax landscape. Since he started this process in 2008, there have been several changes in estate tax law. We've gone from an exemption of $2,000,000 and a tax rate of 45% in 2008, to an exemption of $3,500,000 and tax rate of 45% in 2009, to a full estate tax repeal in 2010, to an exemption of $5,000,000 and a tax rate of 35% in 2011 and 2012. In 2013, the exemption is scheduled to fall back to $1,000,000 with a tax rate of 55%. How can a business owner actually formulate an estate plan if the rules change every year? In the business world, we need to think beyond the current year if we want our companies to thrive. We're typically looking five to ten years out in our strategic plans, trying to move all the pieces on the board to better our chances of growth and prosperity. That is very difficult to do even in the best circumstances, but nearly impossible to do when Washington keeps changing the rules.

Unless the effect of the estate tax is thoroughly examined, it is very difficult to understand the immense burden it places on small business owners by taxing them for creating and growing a business that outlasts them. In my opinion, it is a fundamentally flawed tax because it is, by definition, double taxation and it discourages entrepreneurship. It should be totally repealed. Absent that, I would ask that Congress consider maintaining the current personal exemption and gift and estate tax rates, and equally important, establish a more permanent solution to the estate tax issue. The United States has always been the land of opportunity. Small business owners take tremendous risk at great personal sacrifice, and they truly are the backbone of the American economy. They should be appreciated and encouraged. Allowing the estate tax exemption to fall back to $1,000,000 and the rate to climb to 55% would absolutely devastate a great number of families who are currently working on generational transfers. Imagine the owner of a small hardware store, who after years and years of making mortgage payments, finally owns his own home. Under the $1,000,000/55% scenario, the value of his home, his business and any other assets he might have accumulated, including his retirement savings, cannot exceed $1,000,000 or he'll pay a significant estate tax. We've all heard about the questionable future of our entitlement programs. With that in mind, shouldn't we encourage people to save for their own retirements, rather than allowing them to bank on the government taking care of them once they stop working? When you consider the completely unforeseeable cost of healthcare that many will experience in their senior years, and how long most people live post-retirement, how can government do anything to discourage people from planning and saving for those expenses themselves? If we want to encourage people to be self-sufficient, we should allow them to save as much as they can in their working years so that government will not have to step in and take care of them in retirement. And we should allow them to do that without the underlying fear that if they overestimate what they will need, they and their families will be rewarded with a tax bill.

I respectfully urge you to carefully consider all the ramifications of estate tax policy and establish a long term solution that will allow for generational transfers of family businesses, and I thank you for allowing me to put a more personal perspective on the issue for you. With that I will conclude my comments and would be happy to answer any questions you may have.