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TO: OUR CLIENTS AND FRIENDS

FROM: JACKSON M. PAYNE

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RE: FINANCIAL STRATEGIES FOR YOUR LIVES AND BUSINESSES

DETAILS OF PRESIDENT BIDEN'S PROPOSED REFORMATION
OF CAPITAL GAINS AND TRANSFER AT DEATH RULES

Department of the Treasury Green Book

President Biden, in the recently-released Green Book, has proposed far-reaching changes to the taxation of capital gains and the treatment of property that is gifted or is transferred at death, including taxing capital gains at ordinary income rates and treating the receipt of assets because of death as a realization event. Details of the proposals are below.

Current Law. Long-term capital gains and qualified dividends are taxed at graduated rates under the individual income tax, with 20% generally being the highest rate (23.8% including the net investment income tax, if applicable, based on the taxpayer's modified adjusted gross income).

Moreover, capital gains are taxable only upon realization, such as the sale or other disposition of an appreciated asset. When a donor gives an appreciated asset to a donee during the donor's life, the donee's basis in the asset is the basis of the donor; in effect, the basis is "carried over" from the donor to the donee. There is no realization of capital gain by the donor at the time of the gift, and there is no recognition of capital gain (or loss) by the donee until the donee later disposes of that asset.

When an appreciated asset is held by a decedent at death, the basis of the asset for the decedent's heir is adjusted (usually "stepped up") to the fair market value of the asset at the date of the decedent's death. As a result, any appreciation accruing during the decedent's life on assets that are still held by the decedent at death avoids federal income tax.

Reasons for Change. The Green Book says that preferential tax rates on long-term capital gains and qualified dividends disproportionately benefit high-income taxpayers and provide many high-income taxpayers with a lower tax rate than many low- and middle-income taxpayers. The rate disparity between ordinary income taxes and capital gains and dividends taxes also encourages economically wasteful efforts to convert labor income into capital income as a tax avoidance strategy.

The Green Book continues that, under current law, a person who inherits an appreciated asset receives a basis in that asset equal to the asset's fair market value at the time of the decedent's death; thus, appreciation that accrued during the decedent's life is never subjected to income tax. In contrast, less-wealthy individuals who must spend down their assets during retirement pay income tax on their realized capital gains. This increases the inequity in the tax treatment of capital gains. In addition, the preferential treatment for assets held until death produces an incentive for taxpayers to inefficiently lock in portfolios of assets and hold them primarily for the purpose of avoiding capital gains tax on the appreciation, rather than reinvesting the capital in more economically productive investments.

Moreover, the distribution of wealth among Americans has grown increasingly unequal, concentrating economic resources among a steadily shrinking percentage of individuals, the Green Book says. Coinciding with this period of growing inequality, the long-term fiscal shortfall of the U.S. has significantly increased. Reforms to the taxation of capital gains and qualified dividends will reduce economic disparities among Americans and raise needed revenue.

Proposal. The Green Book contains the following proposals:

Tax capital income for high-income earners at ordinary rates. "Long-term capital gains and qualified dividends of taxpayers with adjusted gross income of more than $1 million would be taxed at ordinary income tax rates, with 37% generally being the highest rate (40.8% including the net investment income tax), but only to the extent that the taxpayer's income exceeds $1 million ($500,000 for married filing separately), indexed for inflation after 2022."

This proposal would be effective for gains required to be recognized after "the date of announcement."

Observation. Presumably, the date of announcement refers to late April when Biden first discussed his proposals.

Treat transfers of appreciated property by gift or on death as realization events. Under the proposal, the donor or deceased owner of an appreciated asset would realize a capital gain at the time of the transfer.

For a donor, the amount of the gain realized would be the excess of the asset's fair market value on the date of the gift over the donor's basis in that asset. For a decedent, the amount of gain would be the excess of the asset's fair market value on the decedent's date of death over the decedent's basis in that asset. That gain would be taxable income to the decedent on "the Federal gift or estate tax return or on a separate capital gains return."

A transfer would be defined under the gift and estate tax provisions and would be valued using the methodologies used for gift or estate tax purposes. However, for purposes of the imposition of this tax on appreciated assets, the following would apply:

First, a transferred partial interest would be its proportional share of the fair market value of the entire property.

Second, transfers of property into, and distributions in kind from, a trust, partnership, or other non-corporate entity, other than a grantor trust that is deemed to be wholly owned and revocable by the donor, would be recognition events.

The deemed owner of a revocable grantor trust would recognize gain on the unrealized appreciation in any asset distributed from the trust to any person other than the deemed owner or the U.S. spouse of the deemed owner, other than a distribution made in discharge of an obligation of the deemed owner. All of the unrealized appreciation on assets of such a revocable grantor trust would be realized at the deemed owner's death or at any other time when the trust becomes irrevocable.

<u>90-year rule</u>. Gain on unrealized appreciation also would be recognized by a trust, partnership, or other noncorporate entity that is the owner of property if that property has not been the subject of a recognition event within the prior 90 years, with such testing period beginning on January 1, 1940. The first possible recognition event for any taxpayer under this provision would thus be December 31, 2030.

Certain exclusions would apply.

♦ <u>Transfers to charity</u>. Transfers by a decedent to a U.S. spouse or to charity would carry over the basis of the decedent. Capital gain would not be recognized until the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would not generate a taxable capital gain. The transfer of appreciated assets to a split-interest trust would generate a taxable capital gain, with an exclusion allowed for the charity's share of the gain based on the charity's share of the value transferred as determined for gift or estate tax purposes.

♦ <u>Tangible property and principal residence</u>. The proposal would exclude from recognition any gain on tangible personal property such as household furnishings and personal effects (excluding collectibles). The $250,000 per-person exclusion under current law for capital gain on a principal residence would apply to all residences and would be portable to the decedent's surviving spouse, making the exclusion effectively $500,000 per couple.

♦ <u>Small business stock</u>. The exclusion under current law for capital gain on certain small business stock under Code Sec. 1202 would also apply.

♦ New $1 million exclusion. In addition to the above exclusions, the proposal would allow a $1 million per-person exclusion from recognition of other unrealized capital gains on property transferred by gift or held at death.

The per-person exclusion would be indexed for inflation after 2022 and would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes (making the exclusion effectively $2 million per married couple).

The recipient's basis in property received by reason of the decedent's death would be the property's fair market value at the decedent's death. The same basis rule would apply to the donee of gifted property to the extent the unrealized gain on that property at the time of the gift was not shielded from being a recognition event by the donor's $1 million exclusion. However, the donee's basis in property received by gift during the donor's life would be the donor's basis in that property at the time of the gift to the extent that the unrealized gain on that property counted against the donor's $1 million exclusion from recognition.

♦ Family owned and operated businesses. Payment of tax on the appreciation of certain family-owned and operated businesses would not be due until the interest in the business is sold or the business ceases to be family-owned and operated.

♦ 15-year payment plan. The proposal would allow a 15-year fixed-rate payment plan for the tax on appreciated assets transferred at death, other than liquid assets such as publicly traded financial assets and other than businesses for which the deferral election is made. The IRS would be authorized to require security at any time when there is a reasonable need for security to continue this deferral. That security may be provided from any person, and in any form, deemed acceptable by the IRS.

To facilitate the transition to taxing gains at gift, death and periodically under this proposal, the IRS would be granted authority to issue any regs necessary or appropriate to implement the proposal, including rules and safe harbors for determining the basis of assets in cases where complete records are unavailable, and reporting requirements for all transfers of appreciated property including value and basis information.

Proposed effective date. The proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2021, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2022.