CHIEF INVESTMENT OFFICE

Tax Alert 2023–03

Income and Transfer Tax Proposals in Administration's Fiscal Year 2024 Budget

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INTRODUCTION

On March 9, 2023, the Biden Administration released its fiscal 2024 Budget ("Budget"). The Budget calls for $6.9 trillion of spending—an increase from current spending levels of about $6.4 trillion—and a wide range of targeted tax increases intended to reduce the deficit by $2.9 trillion over the ten-year Budget window. On that same date, the Treasury Department released its General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals (known as the Greenbook), which includes a more detailed discussion of the various tax proposals in the Budget. Collectively, the President seeks $4.5 trillion in tax increases over the Budget period. These are only proposals, some of which are new and most of which are recycled from last year's Budget. Although the proposed Budget has no chance of making it through the Republican-controlled House, the Budget will frame upcoming political battles on Capitol Hill and will serve as campaign talking points if the President seeks a second term. It will also serve as the President's opening bid in the anticipated debt ceiling negotiations.

Not all of the proposals increase taxes. Among the proposals is an extension of the 2017 tax cuts that are set to expire at the end of 2025—but it would only apply for households making less than $400,000. There are also many tax cuts—remnants of Build Back Better: an enlarged child tax credit, an expanded earned income tax credit, generous health insurance premium tax credits and increased employer-provided childcare tax credits for businesses, to name just a few. This Tax Alert summarizes certain revenue proposals relating to individual income and transfer tax.

Individual income tax

- Re-impose top 39.6% income tax rate on taxable income over $450,000 for married couples and $400,000 for single taxpayers. Effective for tax years beginning on or after January 1, 2023.
- Eliminate preferential capital gains and dividend tax rates for those with taxable income exceeding $1 million (married couples and single taxpayers) and only to extent income exceeds such threshold. The $1 million threshold would be indexed for inflation after 2024. Effective for gain recognized and dividends received after date of enactment.
- Treat transfers of appreciated property by gift or upon death as an income tax realization event.

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- Impose a new minimum income tax on high-net-worth taxpayers equal to 25% of total income, which would include unrealized gains.
- Expand types of income subject to net investment surtax to include all trade and business income over $400,000 and increase surtax rate from 3.8% to 5% to the extent such income exceeds $400,000. Wage and self-employment income above $400,000 to be subject to an additional Medicare surtax of 1.2%.
- Prevent excessive retirement plan accumulations by high-income taxpayers, through additional required minimum distributions for large account balances.
- Limit IRA rollovers and conversions to designated Roth retirement accounts or Roth IRAs.

Transfer tax

- Increase special use valuation deduction for certain real estate.
- Modify tax rules for grantor trusts.
- Curtail rules for Grantor Retained Annuity Trusts.
- Create consistent valuation rules for certain assets.
- Limit duration of generation-skipping transfer tax exempt trusts to no more than two generations below the taxpayer.
- Impose a new requirement for reporting estimated total value of trust assets.
- Limit valuation discounts for intrafamily transfers of certain property.

Corporate and other

- Increase top corporate income tax rate to 28%. Effective for tax years beginning in 2023 (with special phase-in rules for tax years straddling 2022 and 2023). Increase taxes on U.S. companies' foreign profits to 21% from 10.5%.
- Increase tax rate on corporate stock repurchases to 4%. Effective for repurchases on or after January 1, 2023.
- Impose a tax on the unrealized appreciation of property held by a trust, partnership or other non-corporate entity if such property has been held for over 90 years (and not subject to a gains tax during that period). Ninety years would be measured from January 1, 1942, so the first recognition event would be deemed to occur on December 31, 2032.
- Modify rules for deferral of gain from like-kind exchanges.
- Tax carried (profits) interests as ordinary income.
- Require full recapture of depreciation deductions as ordinary income for certain depreciable real property.
- Limit use of Donor Advised Funds to avoid private foundation payout rules.
- Modernize taxation of digital assets.

INCOME TAX PROPOSALS

Increase the top marginal income tax rate for high earners

The proposal—recycled almost verbatim from last year—would increase the top marginal tax rate to 39.6%. The top marginal tax rate would apply to taxable income over $450,000 for married individuals filing a joint return, and $400,000 for unmarried individuals (other than surviving spouses). These thresholds are far lower than the current levels at which taxpayers pay the top income tax rate. Currently, the top tax rate is 37%, which begins when ordinary income exceeds $693,750 for married individuals ($578,125 for unmarried individuals). A married taxpayer with wages of $693,750, would therefore be subject to a tax increase of $11,887. After 2024, the thresholds would be indexed for inflation. The proposal would raise $235 billion and would be effective for the current tax year and retroactive to January 1 for calendar year taxpayers (i.e., taxable years beginning after December 31, 2022).

Tax capital income for high-income earners at ordinary rates

Long-term capital gains and qualified dividends of taxpayers with taxable income of more than $1 million would be taxed at ordinary rates, with 39.6% being the highest proposed rate for 2023 (44.6% including the proposed 5% net investment income tax). The proposal would only apply to the extent that the taxpayer's taxable income exceeds $1 million ($500,000 for married filing separately). The threshold would be indexed for inflation after 2024. The proposal would raise $214 billion and would be effective for gain recognized and for dividends received on or after the date of enactment. An identical proposal was included in the President's Budget last year.

Transfers of appreciated property by gift or on death as realization events

Under the proposal (recycled from the President's prior Budget), the donor or deceased owner of an appreciated asset would realize a capital gain at the time of a transfer. The amount of the gain realized would be the excess of the asset's fair market value on the date of the gift or on decedent's date of death over the decedent's basis in that asset. That gain would be taxable income to the donor or decedent. Capital losses and carry-forwards from transfers at death would be allowed to offset capital gains and up to $3,000 of ordinary income on the decedent's final income tax return, and the tax imposed on gains deemed realized at death would be deductible on the estate tax return of the decedent's estate (if any).

A transfer would be defined under the gift and estate tax provisions and would be valued at the value used for gift or estate tax purposes. However, for purposes of the imposition of this capital gains tax, the following would apply: first, a transferred partial interest generally would be valued at its proportional share of the fair market value of the entire property, provided that this rule would not apply to an interest in a trade or business to the extent its assets are actively used in the conduct of that trade or business, and second, transfers of property into and distributions in kind from a trust, other than a grantor trust that is deemed to

be wholly owned and revocable by the donor, would be recognition events, as would transfers of property to, and by, a partnership or other non-corporate entity, if the transfers have the effect of a gift to the transferee.

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, not including distributions 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. Certain exclusions would apply. Transfers to a U.S. spouse or to charity would carry over the basis of the donor or decedent.

Capital gain would not be realized until the surviving spouse disposes of the asset or dies, and appreciated property transferred to charity would be exempt from capital gains tax. The transfer of appreciated assets to a split-interest (charitable) trust would be subject to this capital gains tax, with an exclusion from that tax allowed for the charity's share of the gain based on the charity's share of the value transferred.

The proposal would exclude from recognition any gain on all 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. Finally, the exclusion under current law for capital gain on certain small business stock would also apply.

In addition to the above exclusions, the proposal would allow a $5 million per-donor exclusion from recognition of other unrealized capital gains on property transferred by gift during life. This exclusion would apply only to unrealized appreciation on gifts to the extent that the donor's cumulative total of lifetime gifts exceeds the basic exclusion amount in effect at the time of the gift (i.e. for 2023 applicable when total lifetime gifts exceed $12.92 million). In addition, the proposal would allow any remaining portion of the $5 million exclusion that has not been used during life as an exclusion from recognition of other unrealized capital gains on property transferred by reason of death. This exclusion would be portable to the decedent's surviving spouse under the same rules that apply to portability for estate and gift tax purposes and would be indexed for inflation after 2023. The recipient's basis in property, whether received by gift or by reason of the decedent's death, would be the property's fair market value at the time of the gift or the decedent's death.

In some instances, a taxpayer can elect to defer the gain. Taxpayers could elect not to recognize unrealized appreciation of certain family-owned and -operated businesses until the interest in the business is sold or the business ceases to be family-owned and operated. Furthermore, 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 proposal would be effective for gains on property transferred by gift, and on property owned at death by decedents dying, after December 31, 2023, and on certain property owned by trusts, partnerships, and other non-corporate entities on January 1, 2024.

Billionaire's tax: minimum income tax of 25%

Current tax law imposes a tax on only recognized gains, with very limited exceptions. Generally, the appreciation of assets without a corresponding sale of the underlying assets does not trigger an income tax event. The Biden Administration, in an effort to "reduce economic disparities among Americans and raise needed revenue," seeks a dramatic change to long-standing rules by imposing a tax on unrealized gains for a limited group of taxpayers. This proposal is targeted to raise an estimated $437 billion in new revenue from only 0.01% of households. Prior proposals to impose a wealth tax or tax on unrealized appreciation have been met with concerns over constitutional issues and unnecessary complexity, let alone lack of support. The current proposal, while not specifically a wealth tax, will likely confront many of the same issues and concerns. As we mentioned last year, it is interesting to note that President Biden did not support a wealth tax during his presidential campaign but is now supporting it by means of a somewhat similar "unrealized appreciation" tax. This proposal, in our view, is dead on arrival in the Republican controlled House.

The "Billionaire's Tax" proposal would impose a new annual minimum tax equal to 25% of total income (up from the 20% proposed last year), only for taxpayers with net wealth (assets less liabilities) exceeding $100 million. "Total income" would be the sum of taxable income and unrealized gain on capital assets and ordinary assets. To arrive at the minimum tax, the product of 25% of total income would be reduced by the current year's regular tax and by prior minimum tax payments.

The minimum tax could be paid all at once or at the election of the taxpayer in five equal annual installments (or nine equal annual installments with respect to the first year of the minimum tax liability).

The minimum tax would apply to taxpayers with net wealth of $100 million but would not fully phase in until net wealth exceeded $200 million.

Valuation of Assets—Taxpayers with wealth greater than $100 million would be required to report to the IRS on an annual basis, separately by asset class, the total basis and total December 31 estimated value of their assets in each specified asset class, along with the total amount of their liabilities.

Tradeable assets (i.e., publicly traded stock) would be valued using end-of-year market prices. Non-tradeable assets would be valued using the greater of the original or adjusted cost basis, the last valuation event from investment, borrowing, or financial statements, or other methods approved by Treasury. Valuations

of non-tradeable assets would not be required annually: instead, their values would be increased by a conservative floating annual return (the five-year Treasury rate plus two percentage points) in between valuations.

If a taxpayer is considered as "illiquid" the taxpayer could elect to include only unrealized gain in tradeable assets in the calculation of their minimum tax liability. A taxpayer making such election would then be subject to a deferral charge on the realization of gains from non-tradeable assets. As proposed, the deferral charge would not exceed 10% of unrealized gains. A taxpayer would be treated as "illiquid" if their tradeable assets make up less than 20% of the taxpayer's wealth.

Effective date: The new minimum tax is proposed to be effective for taxable years beginning after December 31, 2023.

Modify and increase net investment income surtax and Medicare wage surtax

The President's Budget proposes to expand the reach of the net investment income surtax so that it would apply to all trade or business income if the taxpayer's income exceeds $400,000, subject to a phase-in range. In addition, the Budget proposes an increase of 1.2% in the Medicare wage surtax from its current 0.9% to 2.1% for wages over $400,000 and a corresponding increase in the investment surtax of 1.2% from its current 3.8% to 5% for individuals with income over $400,000. Effective date: The expansion of the surtax and the increase in rates would be effective for tax years beginning in or after 2023.

Prevent excessive accumulations by high-income taxpayers in tax-favored retirement accounts

Consistent with several other proposals in the President's Greenbook, these items were initially proposed in the Build Back Better legislation that failed to pass in 2021. The current proposal establishes distribution requirements and contribution restrictions on certain taxpayers who have accumulated large balances in retirement accounts including IRAs, defined contribution plans under 401(a) or 403(a), annuity contracts under 403(b) and deferred compensation plans under 457(b). For individuals with retirement account balances exceeding $10,000,000 and modified adjusted gross income exceeding $450,000 for married taxpayers and $400,000 for single taxpayers, any contributions to IRAs would be treated as excess contributions subject to the 6% annual excise tax. Additionally, taxpayers who are over these limits must take a required distribution equal to 50% of the amount by which their prior year balance exceeds $10,000,000.

If aggregate retirement account balances are greater than $20,000,000, then a floor on the amount of the required distribution would also apply. These taxpayers would be required to take a distribution from their retirement accounts equal to the lesser of: 1) the amount required to bring aggregate retirement account balances down to $20,000,000 and 2) the aggregate balance held in a Roth IRA or other designated Roth account. Furthermore, any required distribution subject to this floor must first come from Roth accounts. Effectively, this would disallow those with aggregate retirement asset balances greater than $20,000,000 from maintaining Roth accounts. Once the retirement balances are below the $20,000,000 threshold, or all Roth assets have been distributed, the 50% annual distribution rule applicable to participants with IRA balances exceeding $10 million would apply. This proposal would apply for tax years beginning after December 31, 2023, and the income and retirement account size thresholds will be adjusted annually for inflation.

Limit rollover and conversions to designated Roth retirement accounts or Roth IRAs

This proposal would eliminate Roth conversions for high income taxpayers ($450,000 of modified adjusted gross income for married taxpayers, $400,000 for single taxpayers). For these taxpayers, only Roth IRAs or Roth designated accounts, or distributions from such accounts, would be permitted to be rolled into Roth IRAs or Roth designated accounts. Additionally, the proposal would prohibit the rollover of non-Roth IRAs and designated accounts that hold after-tax contributions to Roth IRAs or designated accounts for all individuals, regardless of income. Effectively this would eliminate the "back door Roth contribution" strategy which combines after-tax retirement plan contributions with a subsequent Roth conversion to circumvent income limits for Roth IRA contributions. This proposal would be effective for rollovers and distributions after December 31, 2023.

TRANSFER TAX PROPOSALS

Valuation of special use property

Generally, the value of real property for estate tax purposes is based on the property's highest use. However, certain real property used in a family-owned trade or business may be eligible for a reduction in the value of that property to help preserve its current use. The maximum reduction in value is $750,000, adjusted for inflation since 1997; in 2023, the maximum reduction is $1.31 million. The Budget proposal would increase the maximum reduction to $13 million. Such property generally would include real estate used in family farms, ranches, timberland, and similar enterprises. The proposal would apply to the estates of decedents dying on or after the date of enactment.

Reporting of estimated total value of trust assets and other information about the trust

Although most domestic trusts are required to file an income tax return, there is no requirement to report the nature or value of assets held in such trust. The proposal would require certain trusts to report information to the IRS to facilitate the analysis of tax data and development of tax policies. In addition, each trust would be required to report on its income tax return the generation-skipping transfer (GST) tax inclusion ratio of the trust at the time of any trust distribution to a non-skip person, as well as information regarding any trust modification or transaction with another trust that occurred during that year. The Budget states that this information will provide the IRS with information necessary to verify the GST effect of any trust contribution or distribution. The proposal would apply for taxable years ending after the date of enactment.

Use of defined value formula clauses to determine bequests or gifts

Taxpayers often desire to make transfers in a certain amount in order to achieve a particular tax result. Such transfers are generally referred to as "defined value formulas." Often, the formula determines value by reference to the results of IRS enforcement activities. The proposal would provide that if a defined value formula clause is based on IRS involvement, then the value will be the amount reported on the gift or estate tax return. However, a defined value formula clause would be effective if (a) the unknown value is determinable by something identifiable (other than activity of the IRS), such as an appraisal, or (b) the defined value formula clause is used for the purpose of defining a marital or exemption equivalent bequest at death. The proposal would apply to transfers by gift or on death occurring after December 31, 2023.

Exclusion from the gift tax for annual gifts

The first $17,000 of gifts made to each donee in 2023 is excluded from the donor's taxable gifts (and therefore does not utilize any of the donor's lifetime gift and estate tax exemption.) This annual gift tax exclusion is indexed for inflation and there is no limit on the number of donees to whom such gifts may be made in any one year. To qualify, each gift must be of a present interest, rather than a future interest, in the donated property. The proposal would eliminate the present interest requirement. Instead, there would be a new category of transfers and an annual limit of $50,000 per donor, indexed for inflation after 2024. This new $50,000 limit would not provide an exclusion in addition to the annual per-donee exclusion; rather, it would be a further limit on those amounts that otherwise would qualify for the annual per-donee exclusion. For example, a donor's transfers in the new category in a single year in excess of a total amount of $50,000 would be taxable, even if the total gifts to each individual donee did not exceed $17,000. The proposal would be effective for gifts made after December 31, 2023.

Limit duration of generation-skipping transfer (GST) tax exemption

The GST tax is imposed on gifts and bequests by an individual transferor to transferees who are two or more generations younger than the transferor. Each individual has a lifetime GST tax exemption ($12.92 million in 2023) that can be allocated to transfers made by that individual to a grandchild or other "skip person," whether directly or in trust. An allocation of GST exemption to a trust has the potential to exclude from GST tax not only the value to which GST exemption was allocated, but also all subsequent appreciation and accrued income on that value during the existence of the trust.

The proposal would make the GST exemption applicable only to: (a) direct skips and taxable distributions to beneficiaries no more than two generations below the transferor, and to younger generation beneficiaries who were alive at the creation of the trust; and (b) taxable terminations occurring while any person described in (a) is a beneficiary of the trust. The result of these proposals is that the benefit of the GST exemption would not last for a trust's duration. Instead, the GST exemption would only shield the trust assets from GST tax for as long as the life of any trust beneficiary who either is no younger than the transferor's grandchild or is a member of a younger generation who was alive at the creation of the trust. The proposal would apply on and after the date of enactment to all trusts subject to the GST tax, regardless of the trust's inclusion ratio on the date of enactment.

Revamp tax rules for grantor trusts

Grantor Retained Annuity Trusts (GRATs). The proposal would require that the remainder interest in a GRAT at the time the interest is created have a minimum value for gift tax purposes equal to the greater of (i) 25% of the value of the assets transferred to the GRAT or (ii) $500,000 (but not more than the value of the assets transferred). In addition, the proposal would prohibit any decrease in the annuity during the GRAT term and would prohibit the grantor from acquiring in an exchange an asset held in the GRAT without recognizing gain or loss for income tax purposes. Finally, the proposal would require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. These provisions would significantly diminish the appeal of GRATs as an estate planning tool. This proposed change would apply to all GRATs created on or after the date of enactment.

Gain recognition. For grantor trusts that are not fully revocable by the deemed owner, the proposal would treat the transfer of an asset for consideration between a grantor trust and its deemed owner or any other person as a gain recognition event for income tax purposes, which would result in the seller recognizing gain on any appreciation in the transferred asset. Such transfers would include sales as well as the satisfaction of an obligation (such as an annuity or unitrust payment) with appreciated property. This proposal would apply to all transactions between a grantor trust and its deemed owner occurring on or after the date of enactment.

Income tax paid on grantor trusts. The proposal also would provide that the payment of the income tax by the grantor on the income of a grantor trust is a gift. That gift occurs on December 31 of the year in which the income tax is paid (or, if earlier, immediately before the owner's death, or on the owner's renunciation of any reimbursement right for that year) unless the deemed owner is reimbursed by the trust during that same year. The amount of the gift is the unreimbursed amount of the income tax paid. This proposal would apply to all trusts created on or after the date of enactment.

Adjust a trust's GST inclusion ratio on transactions with other trusts

The proposal would treat a trust's purchase of assets from, or interests in, a trust that is subject to GST tax (regardless of the selling trust's inclusion ratio), as well as a purchase of any other property that is subject to GST tax, as a change in trust principal that would require the redetermination of the purchasing trust's inclusion ratio when those assets (or trust interest) are purchased. The proposal would apply to all such transactions occurring after the date of enactment.

GST tax characterization of certain tax-exempt organizations

The proposal would ignore trust interests held by tax-exempt organizations for purposes of the GST tax. As a result, the

inclusion of such an organization as a permissible recipient of a trust would not prevent the occurrence of a taxable termination subject to GST tax. This would be detrimental to the creation of certain trusts designed to defer the GST tax for as long as possible. The proposal would apply in all taxable years beginning after the date of enactment.

Modify the definition of a guaranteed annuity from a charitable lead annuity trust (CLAT)

The proposal would require that the annuity payments made to charitable beneficiaries of a CLAT at least annually must be a level, fixed amount over the term of the CLAT, and that the value of the remainder interest at the creation of the CLAT must be at least 10 percent of the value of the property used to fund the CLAT, thereby ensuring a taxable gift on creation of the CLAT. The proposal would apply to all CLATs created after the date of enactment.

Modify the tax treatment of loans from a trust

The proposal would treat loans made by a trust to a trust beneficiary as a distribution for income tax purposes, carrying out each loan's appropriate portion of distributable net income to the borrowing beneficiary. In addition, a loan to a trust beneficiary potentially would be treated as a distribution for GST tax purposes, thus constituting either a direct skip or taxable distribution, depending upon the generation assignment of the borrowing beneficiary. Within one year after the final payment made on the loan to the trust, a refund of the appropriate amount of GST tax could be requested to be refunded to the payor of the GST tax that was incurred when the loan was made. The proposal would apply to loans made, as well as to existing loans renegotiated or renewed, by trusts after the year of enactment.

Consistent valuation of promissory notes

The proposal would impose a consistency requirement by providing that, if a taxpayer treats any promissory note as having a sufficient rate of interest to avoid the treatment of any foregone interest on the loan as income or any part of the transaction as a gift, that note subsequently must be valued for Federal gift and estate tax purposes by limiting the discount rate to no more than the greater of the actual rate of interest of the note, or the applicable minimum interest rate for the remaining term of the note on the date of death. The proposal would apply to valuations as of a valuation date on or after the date of enactment.

Valuation discounts in certain assets transferred intrafamily

The proposal would provide that the value of a partial interest in non-publicly traded property (real or personal, tangible or intangible) transferred to or for the benefit of a family member of the transferor would be the interest's pro-rata share of the collective fair market value of all interests in that property held by the transferor and the transferor's family members, with that collective value being determined as if held by a sole individual.

In applying this rule to an interest in a trade or business, passive assets would be segregated and valued as separate from the trade or business. Thus, the value of the family's collective interest would be the sum of the value of the interest allocable to a trade or business (not including its passive assets), and the value of the passive assets allocable to the family's collective interest determined as if the passive assets were held directly by a sole individual. Passive assets are assets not actively used in the conduct of the trade or business, and thus would not be discounted as part of the interest in the trade or business.

This valuation rule would apply only to intrafamily transfers of partial interests in property in which the family collectively has an interest of at least 25 percent of the whole. The proposal would apply to valuations as of a valuation date on or after the date of enactment.

CONCLUSION

The President's proposed tax increases are largely a reprise of proposals in last year's Budget. Most of the tax increases (and many of the spending proposals) were not capable of passing a Democratic controlled congress, in the Build Back Better Act and most were jettisoned by the time it morphed into the Inflation Reduction Act. The current tax proposals have even less of a chance with a Republican controlled House. In the end, almost all the current proposals will remain just that: proposals. However, near term they will serve as an opening bid in the upcoming debt ceiling negotiations and longer term, as talking points for a 2024 presidential run.

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